

Letters of Credit and Illegal Contracts: The Limits of the Independence Principle

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I. INTRODUCTION

Letters of credit are versatile financial instruments. One reason for the versatility of letters of credit is their unique legal structure. In trying to describe this legal structure, commentators often refer to letters of credit as “specialty contracts.” By this they mean that letters of credit are contracts that are governed not by common law contract rules but by a special set of rules.¹ Chief among these special rules is the so-called “independence principle.” According to the independence principle, irrevocable letters of credit—whether commercial or standby letters of credit—must be kept separate from, and independent of, the other contracts and agreements which generated them. By keeping the letter of credit separate and independent from the other parts of the overall business transaction, the independence principle insulates the letter of credit from disputes over the performance of collateral agreements and allows the letter of credit to function as a swift and certain payment mechanism. There is, however, one well-recognized exception to the independence principle. According to Uniform Commercial Code section 5-114(2), “fraud in the transaction” may sometimes act to destroy the independence of the letter of credit and to relieve the issuer of the credit from its obligation to pay the beneficiary.²

Although fraud is well recognized as an exception to the independence principle, this Article will demonstrate that a second exception should also be recognized. In proper circumstances, illegality in the underlying transaction should also relieve the issuer of its obligation to pay a letter of credit. While the “illegality exception” has received some recognition in England, it has not yet been explicitly recognized in the United States.³

In order to analyze the impact of this “illegality exception” on the issuer’s payment obligation, Part II of this Article will first describe the structure of the independence principle and its fraud exception as they appear in the provisions of the

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1. The Fifth Circuit, in *East Girard Sav. Ass’n v. Citizens Nat’l Bank & Trust Co.*, 593 F.2d 598 (5th Cir. 1979), stated that a letter of credit is “simply not an ordinary contract. The letter of credit is a unique device developed to meet specific needs of the marketplace.” *Id.* at 603. See also J. DOLAN, *THE LAW OF LETTERS OF CREDIT: COMMERCIAL AND STANDBY CREDITS* ¶¶ 2.01, 2.02 (1984).

2. U.C.C. § 5-114(2)(a), (b). See also *infra* notes 23–24 and 33–34 and accompanying text.

3. See *United City Merchants (Invs.) Ltd. v. Royal Bank of Canada*, [1982] 2 All E.R. 720 (H.L.) (opinion of Lord Diplock) (confirming bank in England justified in refusing to honor that part of a letter of credit draw that was unenforceable in England under English treaty obligations because the payment would have violated Peruvian exchange control regulations). See also *infra* note 132. But see *J. Zeevi & Sons v. Grindlays Bank (Uganda) Ltd.*, 37 N.Y.2d 224, 333 N.E.2d 168, 371 N.Y.S.2d 892, *cert. denied*, 423 U.S. 866 (1975) (New York court upheld attachment of Ugandan issuing bank’s assets in New York for refusing to pay a letter of credit even though under the Exchange Control Act of Uganda, payment by the issuing bank in Uganda would have been illegal).

Uniform Commercial Code (UCC)⁴ and the Uniform Customs and Practice for Documentary Credits (UCP).⁵ Part II will show that, as set forth in the text of the UCP and the UCC, the independence principle is rather narrow in scope; it insulates the letter of credit only from disputes which arise out of the specific commercial or financial transaction that generated the credit. Even with respect to these disputes, the independence principle is not absolute; the UCC permits the independence principle to be breached if a dispute arising out of the underlying transaction involves serious fraud. Neither the UCP nor the UCC, however, deals directly with whether the independence principle also insulates a credit from disputes arising out of transactions having no connection with the credit. While, in the author's view, the independence principle should be extended to cover these situations as well, the extension can only be justified after carefully balancing several factors.

Part III of the Article will then apply this model of the independence principle and its fraud exception to various types of illegality in the underlying contract. It will be shown that while the independence principle should insulate the letter of credit from certain types of illegality in the underlying contract, it should not insulate the credit from the type of illegality in the underlying contract that would expose the issuer of the credit to criminal liability for paying the credit.

II. THE INDEPENDENCE PRINCIPLE OF LETTER OF CREDIT LAW

Before proceeding to analyze the precise limits of the independence principle, it will be helpful by way of introduction to sketch a typical letter of credit transaction—in this case a typical commercial letter of credit transaction.⁶ Seller X in Hamburg, West Germany agrees to sell buyer Y in Newark, New Jersey one million dollars worth of metal bolts, but only on condition that buyer Y provides seller X with an irrevocable⁷ letter of credit issued by First Bank within ten days after the signing of a contract for sale. Assuming that this condition is acceptable to buyer Y, seller X and buyer Y will enter into a written contract for the sale of the metal bolts. This contract is the underlying transaction that will ultimately generate the letter of credit. In this Article, this underlying contract for the sale of the bolts will be referred to as Contract I.

4. Unless otherwise noted, all citations to the UNIFORM COMMERCIAL CODE (UCC) are to the 1987 official text of the UCC and the official comments thereto.

5. Unless otherwise noted, all citations are to the 1983 revision of the UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS, Publication No. 400 of the International Chamber of Commerce.

6. For the purposes of analysis, letters of credit are usually divided into two categories. A commercial letter of credit acts as a payment mechanism in a sale of goods transaction. A standby letter of credit acts as a form of "back-up" payment obligation, usually guaranteeing repayment of a debt. For a brief summary of these two types of credits, see J. DOLAN, *supra* note 1, ¶¶ 3.04, 3.06 (1984). Both the UCP, see U.C.P. art. 1, and article 5 of the UCC, see U.C.C. § 5-102(1), apply to commercial and standby letters of credit.

7. Although revocable letters of credit do exist, see U.C.P. art. 9; U.C.C. § 5-106(3),(4), they are not common. In certain situations (e.g., contracts of sale in which the buyer is given the right to inspect the goods before payment), revocable letters of credit may be appropriate. See Feldman, *Revocable Letters of Credit?*, LETTERS OF CREDIT REPORT, Jan.-Feb. 1988, at 1-3. This Article, however, will discuss only irrevocable letters of credit since they represent the vast majority of outstanding bank credits. When revocable letters of credit are encountered, it is usually because a mistake has been made in labelling the credit. U.C.P. art. 7 (b),(c) provide that unless a credit is clearly indicated to be irrevocable, it should be deemed to be revocable. Compare *Beathard v. Chicago Football Club, Inc.*, 419 F. Supp. 1133 (N.D. Ill. 1976) with *Conoco, Inc. v. Norwest Bank, Mason City*, 767 F.2d 470 (8th Cir. 1985).

Since the contract for sale (Contract I) obligates buyer *Y* to obtain a one million dollar irrevocable commercial letter of credit from First Bank, buyer *Y* will now proceed to obtain the necessary credit. This usually means that buyer *Y* will fill out one of First Bank's preprinted application forms entitled "Application and Agreement for the Issuance of a Commercial Letter of Credit." On the front page of the form—the actual application—buyer *Y* will request First Bank to establish a one million dollar letter of credit in seller *X*'s favor on certain terms and conditions. Since a letter of credit is a documentary instrument, buyer *Y* will specify in the application the precise documents that First Bank must receive as a condition of payment.⁸ In a commercial letter of credit transaction, these documents will usually consist of a commercial invoice, some type of transport document (an ocean bill of lading or an airbill), an insurance certificate, and perhaps a certificate of weight or quality. Buyer *Y* will also specify the type of draft First Bank should receive from seller *X* and the expiry date of the bank's payment obligation.

On the back page of the application form will be listed the terms of the agreement between buyer *Y* and First Bank with respect to the issuance of the letter of credit. First Bank will require buyer *Y* (i) to agree to reimburse First Bank for all payments made under the letter of credit and (ii) to agree to give First Bank a security interest in the documents and goods generated by the contract of sale.⁹ If First Bank agrees to establish the letter of credit for the account of buyer *Y*, it will cosign the application form. This agreement between First Bank (the issuer or issuing bank¹⁰) and buyer *Y* (the customer or applicant for the credit¹¹) will be referred to as Contract II. First Bank will then open the letter of credit on the exact terms and conditions specified by buyer *Y* in Contract II and send the credit to seller *X* (the beneficiary¹²). The actual letter of credit will be referred to as Contract III.¹³

As you can see from this simple illustration, a typical commercial letter of credit is part of a three-contract structure composed of the contract for the sale of goods, the contract to issue the credit, and the letter of credit itself. Although Contract III, the letter of credit contract, is generated by Contracts I and II, it is a separate contract between the issuing bank (First Bank) and the beneficiary (seller *X*). This letter of

8. U.C.P. art. 2 emphasizes the need for the presentation of documents in order to trigger payment of letters of credit. Documentary or standby credits mean arrangements whereby a bank is to pay or accept drafts "against stipulated documents." See also U.C.P. art. 4.

9. For a typical application and agreement for the issuance of a commercial letter of credit, see H. HARFIELD, *BANK CREDITS AND ACCEPTANCES* 310-17 (5th ed. 1974).

10. The UCC applies to letters of credit issued by both banks and nonbanks; hence the UCC uses the term "issuer" to refer to the person issuing a credit. U.C.C. § 5-103(1)(c). The UCP, on the other hand, only applies to letters of credit issued by banks; hence the UCP uses the term "issuing bank" to refer to the person issuing a credit. U.C.P. art. 2.

11. The UCC refers to the one who requests the issuance of the credit as the "customer." U.C.C. § 5-103(1)(g). The UCP refers to this person as the "applicant for the credit." U.C.P. art. 2.

12. Both the UCC and the UCP refer to the person in whose favor the letter of credit is issued as the beneficiary of the credit. U.C.C. § 5-103(1)(d); U.C.P. art. 2.

13. Although the letter of credit is a contract and often referred to as such (see U.C.C. § 5-114 official comment 1), it is still a specialty contract not governed by all of the rules of ordinary contract law. See *supra* note 1.

credit contract, however, is not only a separate contract between the issuing bank and the beneficiary; it is also a contract that is wholly independent of the other two contracts. This bedrock principle of the independence of the letter of credit will now be explored in detail to ascertain precisely when it does and does not apply.

A. Example I—A Dispute Between the Applicant for the Credit and the Beneficiary Arising out of Contract I

In order to pay the purchase price of the metal bolts, applicant (buyer *Y*) has issuer (First Bank) establish an irrevocable one million dollar letter of credit in favor of the beneficiary (seller *X*).¹⁴ The seller-beneficiary, however, unwittingly ships the wrong metal bolts but presents First Bank with shipping documents that are in strict compliance with the terms of the letter of credit. The applicant learns, however, that despite the conformity of the documents, the metal bolts that were shipped are not the metal bolts called for by the terms of the underlying sales contract. The applicant sues First Bank under UCC section 5-114(2) to enjoin payment of the letter of credit.¹⁵

The injunction should be denied.¹⁶ As set forth in both the UCP and the UCC, the independence principle will insulate First Bank's letter of credit from a breach of warranty dispute which (i) arises out of the underlying sales contract (Contract I) and (ii) is between the seller-beneficiary and the buyer-applicant. UCP article 3 states that "credits . . . are separate transactions from the sales . . . contract(s) on which they may be based" and issuing banks should not be bound by these sales contracts "even if any reference whatsoever to such contract(s) is included in the credit."¹⁷ This language envisions a complete separation of the letter of credit (Contract III) from the underlying contract of sale between the seller and the buyer (Contract I) which generated it. Similarly, UCP article 4 provides that parties to a letter of credit

14. U.C.C. § 5-106(1) uses the concept of "establishment" to refer to the point in time when an irrevocable letter of credit becomes truly irrevocable. A letter of credit becomes "established" with respect to the beneficiary "when he receives a letter of credit or an authorized written advice of its issuance." U.C.C. § 5-106(1)(b). After this point in time, the letter of credit cannot be modified or revoked without the consent of the beneficiary. See U.C.C. § 5-106(1)(b), (2). See also *Bryant v. Kerr*, 726 S.W.2d 373 (Mo. Ct. App. 1987) (FDIC liquidator could not unilaterally disaffirm letter of credit).

15. The official text of U.C.C. § 5-114(2)(b) provides that in the absence of intervening holders in due course, a court of "appropriate jurisdiction" may enjoin the issuer from honoring a letter of credit draft if a required document is forged or fraudulent or if there is "fraud in the transaction." The California and Nevada versions of U.C.C. § 5-114, however, do not empower a court to enjoin the issuer from honoring a letter of credit. CAL. COM. CODE § 5-114(2)(b) (West 1964 & Supp. 1988); NEV. REV. STAT. ANN. § 104.5114(2)(b) (Michie 1986). See *New Tech Devs. v. Bynamics, Inc.*, 191 Cal. App. 3d 1065, 236 Cal. Rptr. 746, *aff'd as modified*, 192 Cal. App. 3d 818 (1987). Despite this, California courts may still allow the beneficiary to be enjoined from presenting the draft (as opposed to enjoining the issuer from honoring the draft) when the beneficiary is subject to the jurisdiction of the California courts. See *Mitsui Mfrs. Bank v. Texas Commerce Bank*, 159 Cal. App. 3d 1051, 206 Cal. Rptr. 218 (1984).

16. Courts have consistently refused to allow breach of warranty disputes arising out of the underlying sales contract (Contract I) to interrupt payment of a commercial letter of credit (Contract III). It is irrelevant whether the applicant for the credit seeks to *enjoin* the payment of the credit based on the alleged breach of warranty, see, e.g., *Tandy Brands, Inc. v. Master Mktg. Ass'n*, 481 So. 2d 925 (Fla. App. 1985), or the applicant seeks to *attach* the proceeds of the credit based on the alleged breach of warranty, see, e.g., *Hohenberg Co. v. Comitex Knitters Ltd.*, 104 Misc.2d 232, 428 N.Y.S.2d 156 (Sup. Ct. 1980), or the bank *decides on its own* to refuse to honor the credit based on the alleged breach of warranty with respect to the underlying goods, see, e.g., *Maurice O'Meara Co. v. National Park Bank*, 239 N.Y. 386, 396, 146 N.E. 636, 639 (1925); *Weyerhaeuser Co. v. First Nat'l Bank*, 27 U.C.C. Rep. Serv. (Callaghan) 777, 780-82 (S.D. Iowa 1979).

17. U.C.P. art. 3.

transaction "deal in documents" and not "in goods . . . to which the documents may relate."¹⁸ The subject of the sales contract (Contract I) is the goods; the subject of the commercial letter of credit contract (Contract III) is the shipping documents. UCP article 4 emphasizes that the concerns of each contract are separate and, as a result, the issuer and the beneficiary of the credit must deal in documents and avoid dealing in the goods that are the concern of the sales contract between the seller and the buyer.

Two sections of the UCC are also relevant in this regard. UCC section 5-109(1)(a) provides that a letter of credit issuer is not responsible "for performance of the underlying contract for sale."¹⁹ Similarly, UCC section 5-114(1) provides that the issuer of a credit must honor a credit if the demand for payment complies with the terms of the credit "regardless of whether the goods or documents conform to the underlying contract for sale . . . between the customer and the beneficiary."²⁰

The result mandated by the text of both UCP articles 3 and 4 and UCC sections 5-109(1) and 5-114(1) seems to be correct from a commercial and economic policy perspective. To prove this point, assume for the sake of argument that there were no independence principle in letter of credit law. In such a legal regime, how would seller *X* and buyer *Y* negotiate a contract for the sale of metal bolts that would both reduce the risks inherent in an international sale of goods transaction and still be the cheapest and most efficient contract possible? If seller *X* and buyer *Y* are both merchants, they presumably have already invested the time and the money in acquiring expertise regarding metal bolts and the buying and selling of these bolts. What seller *X* and buyer *Y* need is not another metal-bolt merchant, but an independent intermediary who can reduce the credit, financial, and documentary risks involved in an international sale transaction between metal-bolt merchants in different countries. First Bank does not have expertise regarding metal bolts, but it does have expertise regarding the checking of documents and the transferring of money. For a fee,²¹ First Bank is willing to make its expertise available to seller *X* and buyer *Y*. If the three parties all agree to allocate contractual responsibilities in the cheapest and most efficient way possible, they would essentially write the independence principle into their contractual arrangements. By contract, First Bank would undertake the examination of documents, the payment of money, and the investigation of credit risks, but would not undertake to resolve matters pertaining either to the metal bolts or to the shipping of the bolts. Seller *X* and buyer *Y* already have the necessary expertise to resolve matters regarding the bolts, and if First Bank were contractually obligated to police such matters, First Bank would have to charge seller *X* and buyer *Y* a fee to acquire the expertise necessary to resolve these goods-related

18. U.C.P. art. 4.

19. U.C.C. § 5-109(1)(a).

20. U.C.C. § 5-114(1).

21. The UCC provides that "[n]o consideration is necessary to establish a credit . . ." U.C.C. § 5-105. While this is true as a matter of law, banks obviously charge a fee for issuing letters of credit. U.C.C. § 5-105 official comment 1. In *Exxon Co., U.S.A. v. Banque de Paris et des Pays-Bas*, 828 F.2d 1121 (5th Cir. 1987), *judgment vac. and case rem.*, 109 S.Ct. 299 (1989), the bank's fee for issuing a \$19,530,000 standby letter of credit was reported to be \$53,000. *Id.* at 1122.

matters.²² This would be inefficient since seller X and buyer Y would be paying twice for the same expertise. Furthermore, First Bank would probably not be able to spread the cost of acquiring this expertise regarding metal bolts over many transactions because, if it is a typical issuing bank, First Bank will issue letters of credit in a wide variety of sales transactions involving many different types of goods. Thus, the most efficient way to allocate contractual responsibilities would be to require First Bank to police documentary, money, and credit matters and seller X and buyer Y to police matters involving the metal bolts. In this way, the independence principle would be the end product of seller-buyer-bank negotiations over the cheapest and most efficient way to protect against risks that might arise in the international sale of the metal bolts.

B. Example 2—A Dispute Between the Applicant for the Credit and the Beneficiary Involving Fraud in Contract I

Buyer Y agrees to purchase metal bolts from seller X after seller X fraudulently dupes buyer Y into believing that the metal bolts will be compatible with buyer Y's manufacturing equipment. In reality, however, the bolts are not compatible with buyer Y's equipment, and because of certain unusual characteristics in their design, the bolts will not be resalable by buyer Y. To pay for the bolts, buyer Y (the applicant for the credit) has First Bank (the issuer) establish an irrevocable one million dollar letter of credit in favor of seller X (the beneficiary). Among other things, payment of the credit is conditioned on the seller-beneficiary's presentation of a certificate stating that the bolts shipped are compatible with buyer Y's manufacturing equipment. The seller-beneficiary presents a certificate in strict compliance with the terms of the credit. Applicant-buyer Y, however, learns of the fraud before First Bank honors the credit and sues to enjoin payment.

As long as there is no holder in due course involved in the transaction, UCC section 5-114(2) permits a court to enjoin the issuer from honoring a letter of credit if, *inter alia*, a required document is "fraudulent" or there is "fraud in the transaction."²³ According to the majority view, "fraud in the transaction" means fraud in the underlying transaction which generated the credit.²⁴ Since, in Example

22. In the English case of *Rayner v. Hambros Bank*, [1943] 1 K.B. 37, 41 (C.A.), Lord Mackinnon stated that "it is quite impossible to suggest that a banker is to be affected with knowledge of the customs . . . of every one of . . . thousands of trades . . ." In *Board of Trade v. Swiss Credit Bank*, 728 F.2d 1241 (9th Cir. 1984), there was a dispute as to whether an airbill could be substituted for a required ocean bill of lading under the credit. The court noted: "The issuer of a letter of credit should not be placed in the position of having to determine whether an unauthorized method of shipment is material. In this instance, whether air shipment would have been considered hazardous by the parties or apt to cause damage to sensitive electronic equipment is not the type of evaluation that should be required in a transaction where promptness and certainty are of the essence." *Id.* at 1243.

23. In relevant part, the UCC provides that "[u]nless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document . . . is forged or fraudulent or there is fraud in the transaction . . . (b) [in cases not involving a holder in due course] as against its customer, an issuer acting in good faith may honor the draft . . . despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honor." U.C.C. § 5-114(2)(b). *See also supra* note 15.

24. For the majority view, see *Rockwell Int'l Sys., Inc. v. Citibank, N.A.*, 719 F.2d 583, 588-89 (2d Cir. 1983). For a discussion of the minority view, see *infra* text accompanying notes 33-36. It should be noted, however, that in Example 2, seller X presented First Bank with a required document that was "fraudulent"—the certificate stating that the metal bolts were compatible with buyer Y's manufacturing equipment. Arguably, buyer Y's injunctive action could be

2, it is seller *X*'s fraud in inducing buyer *Y* to purchase the incompatible metal bolts that provides the basis for buyer *Y*'s attempt to enjoin payment of the credit, the majority view would allow seller *X*'s fraud vis-à-vis the buyer in Contract I to percolate up and affect First Bank's payment obligation in Contract III.

Fraud, however, is an inherently pliable concept. Not unexpectedly, courts have disagreed over the precise nature of the fraud required to satisfy UCC section 5-114(2). Recognizing that a letter of credit must be protected from simple contract disputes, such as the breach of warranty dispute in Example 1, and recognizing also that there is often no bright line between simple contract disputes and certain fraud claims, many courts require a showing of "active"²⁵ or "egregious"²⁶ fraud in order to satisfy UCC section 5-114. By requiring this higher degree of fraud, these courts implicitly are trying to protect the letter of credit mechanism from disputes that are only arguably fraudulent. Before they will issue a UCC section 5-114(2) injunction, these courts demand that the applicant demonstrate that the beneficiary's conduct in performing the underlying contract is so outrageous that it effectively robs the applicant of the entire benefit of his bargain. To protect the letter of credit mechanism further, courts sometimes demand that the "egregious" or "active" fraud be perpetrated directly by the beneficiary and not by some third party such as a shipper or a freight forwarder.²⁷

Thus, in Example 2, assuming that buyer *Y*, the applicant for the credit, can meet the stringent proof requirements necessary for equitable relief,²⁸ a UCC section 5-114(2) injunction should perhaps be issued. First, the fraud in Example 2 is "egregious" in the sense that the seller-beneficiary is intentionally providing the

based on the presentation of this fraudulent document in Contract III rather than on seller *X*'s fraudulent conduct in Contract I. Granting an injunction based on the presentation of a fraudulent document would not require breaching the independence principle because the fraud would directly relate to Contract III. This logic is not persuasive, however. To determine the fraudulent nature of seller *X*'s certificate, a court would necessarily have to look at seller *X*'s fraudulent conduct in inducing buyer *Y* to purchase metal bolts that were incompatible with his manufacturing equipment. Similarly, to determine that the metal bolts were not resalable to others—a fact stated in Example 2—a court would have to consider the underlying sales contract between seller *X* and buyer *Y*. Consequently, even if, in granting an injunction, a court were to rely on the "fraudulent document" language in U.C.C. § 5-114, the court would still have to look at events in Contract I before granting the injunction, thus breaching the independence principle. On the confusion in meaning between the U.C.C. § 5-114 phrases "a required document . . . is . . . fraudulent" and "fraud in the transaction," see J. WHITE & R. SUMMERS, *UNIFORM COMMERCIAL CODE* § 19-7 (3d ed. 1988); J. DOLAN, *supra* note 1, ¶ 7.04; 6 HAWKLAND, *UNIFORM COMMERCIAL CODE SERIES*, § 5-114:09 (1982).

25. See *Sztejn v. Schroder Banking Corp.*, 177 Misc. 719, 722, 31 N.Y.S.2d 631, 635 (Sup. Ct. 1941).

26. See *Offshore Trading Co. v. Citizens Nat'l Bank*, 650 F. Supp. 1487, 1492 (D. Kan. 1987); *Colorado Nat'l Bank v. Board of County Comm'rs*, 634 P.2d 32, 39 (Colo. 1981) (en banc).

27. The leading case on this point is the English House of Lords decision in *United City Merchants (Invs.) Ltd. v. Royal Bank of Canada*, [1982] 2 All E.R. 720, 726 (H.L.). This aspect of *United City Merchants* has been impliedly followed in several American cases involving the Federal Deposit Insurance Corporation. See *FDIC v. Bank of San Francisco*, 817 F.2d 1395 (9th Cir. 1987); *Larson v. First Interstate Bank*, 603 F. Supp. 467, 469-70 (D. Ariz. 1983).

28. For one statement of the requirements for injunctive (equitable) relief in the letter of credit context, see *Harris Corp. v. National Iranian Radio & Television*, 691 F.2d 1344, 1353 (11th Cir. 1982).

applicant-buyer with worthless metal bolts²⁹ and second, the seller-beneficiary is directly perpetrating the fraud.

But, despite the textual support in UCC section 5-114(2) for issuing fraud injunctions, the result in Example 2 is arguably incorrect—at least from an economic policy perspective. To obtain an injunction, buyer *Y* has the burden of proving, *inter alia*, that there is a substantial likelihood that seller *X* has fraudulently duped buyer *Y* into purchasing worthless metal bolts.³⁰ If, in defending against buyer *Y*'s injunction action, First Bank were required to controvert this evidence, First Bank most likely would have to involve itself in Contract I disputes regarding the compatibility of the metal bolts with buyer *Y*'s manufacturing equipment.³¹ As we have seen, this would be economically inefficient given First Bank's lack of mercantile expertise vis-à-vis metal bolts. However, if permitting fraud injunctions is inefficient, the inefficiency is at least only marginal. First of all, to defend against buyer *Y*'s injunction action, First Bank would not necessarily have to analyze the quality or nature of the metal bolts. First Bank could defend by contesting buyer *Y*'s showing either that he has been irreparably injured or that the balance of equities tilts in his favor.³² Even if First Bank were required to controvert directly buyer *Y*'s evidence that seller *X* has fraudulently shipped worthless metal bolts, at least First Bank would not be required to make a detailed analysis of the bolts. Because buyer *Y* must meet a heavy burden in proving each of the elements for injunctive relief, First Bank would only be required to assess whether buyer *Y*'s evidence convincingly and overwhelmingly demonstrates that seller *X* has shipped worthless metal bolts. Requiring First Bank to make this rather superficial evaluation of the underlying transaction is not the same thing as requiring First Bank to have a detailed

29. Injunctions have been granted in cases where the goods shipped were worthless. See *United Bank Ltd. v. Cambridge Sporting Goods Corp.*, 41 N.Y.2d 254, 360 N.E.2d 943, 392 N.Y.S.2d 265 (1976); *Sztejn v. Schroder Banking Corp.*, 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941). See also *Phillip Bros. v. Oil County Specialists*, 709 S.W.2d 262 (Tex. Ct. App. 1986) (injunction to block payment of a standby letter of credit granted because the inventory of goods covered by the letter of credit was virtually worthless).

30. See *Harris Corp. v. National Iranian Radio & Television*, 691 F.2d at 1353 (11th Cir. 1982).

31. Since in order to obtain an injunction buyer *Y* must introduce evidence that he will most likely prevail on the merits (*i.e.*, that he will most likely be able to prove fraud in the underlying transaction), First Bank should logically introduce evidence to controvert this fact. This would seem to involve First Bank in analyzing the underlying contract. This involvement, of course, contradicts the rules of letter of credit practice found in the UCP. The UCP states that in letter of credit operations "all parties concerned deal in documents, and not in goods . . . to which the documents may relate." U.C.P. art. 4. But in *Bank of Canton, Ltd. v. Republic Nat'l Bank*, 509 F. Supp. 1310, 1319 (S.D.N.Y.), *aff'd mem.*, 636 F.2d 30 (2d Cir. 1980) (*per curiam*), the issuing bank did not contest the grant of an injunction and then subsequently relied on the injunction to justify dishonor of the credit. The court ruled that the bank could not rely on the injunction in these circumstances. Thus, an issuing bank's "no-contest" posture with respect to a fraud injunction may not free it from its obligation to pay. Dishonor will probably be wrongful, subjecting the bank to damages under U.C.C. § 5-115(1), and perhaps even to punitive damages. Apart from involving First Bank in disputes relating to the underlying contract, defending against an injunction may have another deleterious effect on the issuing bank's payment commitment. The injunction may extend the expiry date of the bank's commitment.

32. See *supra* note 28. In *Asbury Park & Ocean Grove Bank v. National City Bank*, 35 N.Y.S.2d 985 (Sup. Ct. 1942), *aff'd mem.*, 268 A.D. 984, 52 N.Y.S.2d 583 (1944), the New York court noted the plight of the issuing bank when involved as a defendant in a fraud action brought by the applicant for the credit. "The common-law fraud action is one of the most difficult to prove, and the issuing bank cannot be expected to evaluate the soundness of the . . . claim." *Id.* at 989.

understanding either of the particular nature of metal bolts or of contracts dealing with the sale of metal bolts.

There is a more conservative reading of the UCC section 5-114(2) fraud exception, however. According to this minority view, the phrase "fraud in the transaction" should be read to mean fraud in the presentation of the Contract III documents, not fraud in the performance of Contract I.

As the Ninth Circuit pointed out in *FDIC v. Bank of San Francisco*,³³ this view is more consistent with the basic rationale of the independence principle—that the letter of credit should be kept insulated from all disputes arising out of contracts which generated it. In addition, the Ninth Circuit might have pointed out that this reading is also more consistent with economic efficiency principles. Reading "fraud in the transaction" to mean fraud in the presentation of documents limits First Bank's analysis to events in Contract III, obviating the need for even the superficial evaluation of Contract I required in Example 2.³⁴

Although there may be much to commend this reading of "fraud in the transaction," the reading is not supported by either the text of UCC section 5-114(2) or the seeming intent of its drafters. If "fraud in the transaction" were read to mean fraud in the documents presented, this reading would violate a basic canon of statutory construction—namely, that every word in the text of a statute should be given independent significance. UCC section 5-114(2) already permits the issuance of an injunction when a required document presented is "fraudulent." Thus, reading the words "fraud in the transaction" as fraud in the documents presented would make them redundant. Of course, to avoid this statutory construction problem, one could read the words "fraud in the transaction" not as fraud in the documents presented in Contract III, but rather as fraud in the draft presented in Contract III. Under the UCC, the draft or demand presented by the beneficiary to obtain payment under a letter of credit is not treated as a document.³⁵ Thus, there would be no redundancy in the statute if the words "fraud in the transaction" were read to cover a case in which a fraudulent draft was presented in the Contract III transaction and the words "fraudulent document" were read to cover a case in which a fraudulent invoice or transport document was presented in the Contract III transaction. Essentially this interpretation would limit the use of "fraud in the transaction" to "clean letters of credit"—cases in which only drafts are presented to obtain payment.³⁶

While this interpretation would solve the statutory construction problem mentioned above, it would do violence to the seeming intent of the drafters of UCC section 5-114(2). Apparently, the drafters wished to codify in UCC section 5-114(2)

33. 817 F.2d 1395 (9th Cir. 1987). See *supra* note 27.

34. But see the analysis *supra* note 24.

35. U.C.C. § 5-103(1)(b) defines a "documentary draft" or a "documentary demand for payment" as one, the honor of which is conditioned upon the presentation of documents. In UCC terminology, the "draft" or payment demand is clearly separate from the documents which accompany it. A "draft" is defined in U.C.C. § 3-104(2)(a) as an "order," a kind of negotiable instrument.

36. For the definition of a "clean" letter of credit as a credit requiring only the presentation of a draft, see, e.g., *Baker v. National Blvd. Bank*, 399 F. Supp. 1021, 1024 (N.D. Ill. 1975). See also *Apex Oil Co. v. Archem Co.*, 770 F.2d 1353, 1355 (5th Cir. 1985); *Enso Env'tl. Servs., Inc. v. United States*, 650 F. Supp. 583, 589 (W.D. Mo. 1986).

the holding of *Sztejn v. Schroder Banking Corp.*, which permitted active fraud in Contract I—the shipping of garbage in lieu of bristles for hair brushes—to block the issuing bank's Contract III payment obligation.³⁷

In this Article, the majority view of “fraud in the transaction” as set forth in the analysis of Example 2 will be followed.

C. Example 3—A Dispute Between the Issuing Bank and the Applicant for the Credit Arising out of Contract II

Seller X, the beneficiary of First Bank's irrevocable letter of credit, presents his draft and the requisite shipping documents to First Bank for payment. Unfortunately, since the date when the letter of credit was first opened, buyer Y (the applicant) has filed for bankruptcy. Because of the automatic stay of section 362 of the Bankruptcy Code,³⁸ First Bank knows that if it pays the credit and takes possession of the documents, it will not be able to seek reimbursement from buyer Y by immediately foreclosing its security interest in the bankrupt's property, *i.e.*, the documents and the metal bolts represented by those documents.³⁹ Although the draft and documents strictly comply with the terms of the letter of credit,⁴⁰ First Bank dishonors the credit and notifies seller X of this fact. Seller X sues First Bank for wrongful dishonor of the credit.

Seller X should prevail in his suit. Once the irrevocable letter of credit is established in favor of the beneficiary, First Bank cannot cancel or otherwise modify the terms of its payment obligation.⁴¹ The fact that the applicant (buyer Y) subsequently files for bankruptcy has no effect on First Bank's payment obligation. The applicant's inability to reimburse First Bank for payments made to the beneficiary involves a default by the applicant on its Contract II obligation to First Bank. Just as with disputes arising out of Contract I, the letter of credit obligation (Contract III) must be kept separate from and independent of defaults and disputes arising out of the reimbursement agreement (Contract II).

UCP article 6 provides a textual basis for keeping Contract III separate and independent from Contract II. UCP article 6 provides that “[a] beneficiary can in no

37. 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941). On the intent of the drafters of U.C.C. § 5-114, see, *e.g.*, Note, “*Fraud in the Transaction*”: *Enjoining Letters of Credit During the Iranian Revolution*, 93 HARV. L. REV. 992, 1002 (1982). It should be pointed out that fraudulent documents were also present in the *Sztejn* case.

38. The automatic stay of the Bankruptcy Code is found in 11 U.S.C. § 362 (1982 & Supp. 1986).

39. If the issuing bank pays the beneficiary's draft under a credit and becomes the holder of a negotiable bill of lading, the issuing bank will presumably acquire “title” both to the bill of lading and to the goods it represents. U.C.C. § 7-502. Query whether the issuing bank's “title” to the document of title and to the goods means that the bank could sell the bill of lading and/or the goods without violating the automatic stay. Given that the bank does not usually intend to acquire title to the document or to the goods through purchasing the bill of lading, the better view would be to treat the bank's interest in the document of title and the goods as a security interest. Therefore, upon the bankruptcy of the debtor, the bank would be subject to the automatic stay. Cf. J. DOLAN, *supra* note 1, ¶ 8.04(2).

40. According to the overwhelming majority view, the issuer must pay if the draft and the documents presented strictly comply with the terms and conditions of the letter of credit. See, *e.g.*, *Armac Indus., Ltd. v. City Trust*, 203 Conn. 394, 525 A.2d 77 (1987) for a list of commentators and leading cases which have adopted this majority view.

41. In *InterFirst Bank Greenspoint v. First Fed. Sav. & Loan Ass'n*, 242 Kan. 181, 747 P.2d 129 (1987), the court noted that even fraudulent acts perpetrated by the applicant with respect to the issuing bank's decision to issue a credit (Contract II) does not relieve the issuing bank of its obligation to pay the beneficiary of the credit.

case avail himself of the contractual relationships existing . . . between the applicant for the credit and the issuing bank.”⁴² By its terms, UCP article 6 prohibits the beneficiary in Contract III from claiming to be a third party beneficiary of the applicant’s Contract II rights against the issuing bank.⁴³ UCP article 6 should also be read in reverse as prohibiting the issuing bank from using its Contract II defenses (those against the applicant) against the beneficiary in Contract III. Thus, the bankruptcy of the applicant and the subsequent default by the applicant on its Contract II reimbursement obligation cannot be used by the issuing bank to justify dishonor of its Contract III payment obligation to the beneficiary.

Although no provision of the UCC deals directly with the independence of Contract II from Contract III, UCC section 5-105 has at least indirect relevance. UCC section 5-105 provides that, unlike an ordinary contract, “no consideration is necessary to establish a [letter of] credit.”⁴⁴ The reason for this rule is easy to understand. If the beneficiary’s rights under a letter of credit were made contingent on whether or not the applicant paid the issuing bank a fee for opening the credit, every beneficiary of a credit would first have to investigate whether the issuance fee had been paid before it could feel secure in relying on the credit.⁴⁵ By causing delay and increasing costs, this rule would weaken the usefulness of a letter of credit. Thus, UCC section 5-105 adopts the most economically efficient rule by making the issuing bank’s letter of credit obligation binding regardless of whether the applicant pays the bank an issuance fee.

By parity of reasoning, the issuing bank’s letter of credit obligation should be binding regardless of whether the applicant can reimburse the bank for any payments made under the credit. If the issuing bank’s payment obligation under a letter of credit were contingent upon its being reimbursed by the applicant, the beneficiary would always have to investigate the creditworthiness of the applicant before it could be sure of the issuing bank’s obligation. When it takes a letter of credit, however, the beneficiary is relying on the creditworthiness of the issuing bank, not on the creditworthiness of the applicant. When the issuing bank establishes a letter of credit in the beneficiary’s favor, the issuing bank assumes the risk that the applicant will not be able to pay for the documents. Thus, applying the policy adopted by UCC section 5-105 to this Contract II reimbursement issue, a process encouraged by UCC section 5-102(3),⁴⁶ Contract III should be kept separate from and independent of disputes arising out of Contract II involving the applicant’s ability to reimburse the issuing bank.⁴⁷

42. U.C.P. art. 6.

43. Sometimes a court or a commentator will analyze a letter of credit as a form of third party beneficiary contract. The independence principle of letter of credit law, however, precludes rights or defenses derived from one contract to be used in another contract.

44. U.C.C. § 5-105.

45. See U.C.C. § 5-105 official comment.

46. U.C.C. § 5-102(3) “makes explicit the court’s power to apply a particular rule by analogy to cases not within its terms” U.C.C. § 5-102 official comment 2. See *Arbest Constr. Co. v. First Nat’l Bank & Trust Co.*, 777 F.2d 581, 585 (10th Cir. 1985) (the Tenth Circuit affirmed that U.C.C. § 5-102(3) gives courts leeway to apply existing statutory rules to new letter of credit variations).

47. In *Baker v. National Blvd. Bank*, 399 F. Supp. 1021 (N.D. Ill. 1975), the federal district court stated that

D. *Example 4—A Dispute Between the Beneficiary and the Applicant for the Credit Arising out of a Contract Unrelated to the Letter of Credit Contract*

1. *Claim Brought by the Applicant Against the Beneficiary*

Seller X, the beneficiary of First Bank's irrevocable letter of credit, presents its draft and the requisite shipping documents to First Bank to obtain payment for the metal bolts. The day after the seller-beneficiary presents its draft and documents to First Bank but before First Bank pays, the applicant (buyer Y) sues seller X on a cause of action totally unrelated to the letter of credit transaction. As part of this unrelated litigation, buyer Y attempts to attach the proceeds of the letter of credit owed seller X by First Bank.⁴⁸

Neither the UCP nor the UCC directly supports extending the independence principle to cover disputes involving *unrelated* contracts between the beneficiary and the applicant for the credit. UCP article 3 and UCC sections 5-109 and 5-114 insulate the letter of credit only from disputes involving the specific underlying contract which generated the credit. It is true that UCC section 5-114(1) provides that the issuer of a credit must pay when the documents comply with the terms of the credit "regardless of whether the goods or documents conform to the underlying contract for sale or *other contract* between the customer and the beneficiary."⁴⁹ While some might try to interpret the words "other contract" to mean "any other contract between the applicant and the beneficiary regardless of whether that contract generated the credit," the words are more correctly interpreted to mean "any contract between the applicant and the beneficiary which generated the letter of credit, *other than a sales contract*." Since UCC article 5 covers standby as well as commercial letters of credit, UCC section 5-114(1) merely states that a letter of credit is independent of whatever type of underlying contract—sales contract, loan agreement, etc.—which generated it.

But UCC section 5-102(3) does provide a basis for applying the UCC section 5-114(1) independence principle outside of its precise limits. In relevant part, UCC section 5-102(3) provides that "[t]he fact that [article 5] states a rule does not by itself require, imply or negate application of the same or a converse rule to a situation not provided for or to a person not specified by this Article."⁵⁰ Thus, even though by their specific terms UCC sections 5-114(1) or 5-109(1) do not insulate a letter of

"[t]here is no authority giving an issuer the right to refuse to pay a beneficiary if the issuer fears it cannot collect from its customer." *Id.* at 1024. In *Schweibish v. Pontchartrain State Bank*, 389 So. 2d 731 (La. Ct. App. 1980), the issuing bank seemed to be influenced in dishonoring a letter of credit by the financial difficulties of the applicant for the credit. Still the bank was not permitted to avoid the credit. *Id.* at 736. See also *Temtex Prods., Inc. v. Capital Bank & Trust Co.*, 623 F. Supp. 816 (M.D. La. 1985); *InterFirst Bank Greenspoint v. First Fed. Sav. & Loan Ass'n*, 747 P.2d 129 (Kan. 1987).

48. The statutory grounds for attachment differ from state to state. In New York, for example, the statutory grounds are listed in N.Y. CIV. PRAC. L. & R. 6201 (McKinney 1980). Throughout this Article, it is assumed that the applicable statutory requirements for attachment have been satisfied. The issue discussed is whether attachments of letter of credit proceeds are appropriate even when the statutory requirements are satisfied.

49. U.C.C. § 5-114(1) (emphasis added).

50. U.C.C. § 5-102(3).

credit from disputes between the applicant and the beneficiary arising out of a contract *unrelated* to the letter of credit transaction, UCC section 5-102(3) still permits the rule contained in these sections to be adapted analogically to a situation for which the UCC does not specifically provide.⁵¹

Analogical reasoning requires, first, an understanding of the commercial policies underlying the rule to be applied and, second, a careful analysis of whether these policies would justify applying the rule to the different situation.

a. *The Policies Underlying the Independence Principle*

The policies underlying the independence principle are aimed at protecting the beneficiary, the issuing bank, and, perhaps most importantly, the letter of credit mechanism itself.

i. *The Independence Principle Protects the Beneficiary*

Until a seller is paid for its goods, it bears the risk that the buyer will either become insolvent, delay payment, or try to obtain a price reduction based on some real or imagined defect in the goods.⁵² A seller may decide to eliminate these risks with respect to this buyer by demanding a letter of credit from the buyer's bank. The purpose of the independence principle is to keep the issuing bank obligated to pay the seller despite problems which may develop over the buyer's solvency or over the quality or price of the goods. Thus, in the typical case, the independence principle protects the seller-beneficiary by assuring that it will be the stakeholder of the proceeds of the letter of credit during any subsequent litigation over the quality or price of the goods or the creditworthiness of the buyer.

ii. *The Independence Principle Protects the Issuing Bank*

When the buyer-applicant requests the issuing bank to open a letter of credit, the issuing bank charges the applicant a fee commensurate with its risks and responsibilities under the credit. In order to keep the letter of credit a relatively inexpensive payment mechanism, the issuing bank has traditionally been responsible only for document examination and payment, not for investigating matters relating to the performance of the underlying commercial or financial transaction. As seen earlier, insulating the issuing bank from these matters makes sense from an economic efficiency perspective. Since a bank issues letters of credit in a wide variety of transactions, from construction contracts to sales of metal bolts and offerings of municipal bonds, it would be costly and inefficient to require an issuing bank to expend resources learning about the particulars of each of these contracts.⁵³ The

51. See *supra* note 46.

52. See generally J. WHITE & R. SUMMERS, *UNIFORM COMMERCIAL CODE* § 19-1 (3d ed. 1988).

53. One court noted that there has been "a recent explosive growth in use of standby letters of credit." *Arbest Constr. Co. v. First Nat'l Bank & Trust Co.*, 777 F.2d 581, 585 (10th Cir. 1985). For a partial list of transactions where standby letters of credit may be utilized, see McLaughlin, *Recent Developments in Standby Letters of Credit*, in *LEGAL ISSUES IN BANK LENDING*, November 16-17, 1987 (Executive Enterprises, Inc. 1987).

details of performance of each of these contracts are policed more cheaply and efficiently by the merchants and businessmen who negotiated them. Thus, the independence principle protects the issuing bank, first, by efficiently allocating responsibilities in the letter of credit transaction and, second, by keeping the issuing bank's responsibilities commensurate with the fee it charges.

iii. *The Independence Principle Protects the Letter of Credit Mechanism*

Because a letter of credit virtually assures a beneficiary of payment, other parties may agree to become part of the letter of credit transaction relying on the beneficiary's assurance of payment. Two examples should suffice.

Occasionally a beneficiary of a letter of credit may be a broker or middleman who must buy the goods from a supplier in order to resell them to the applicant. To pay the supplier for these goods, the beneficiary may ask a second bank to issue a "back to back" letter of credit in favor of the supplier. As security for issuing such a credit, the second bank will take back an assignment of proceeds of the first letter of credit.⁵⁴ The independence principle protects this second bank's collateral (the proceeds of the first credit) from being affected by disputes arising out of the sale of goods contract between the broker and the buyer.

Assuming the terms of the letter of credit permit it, a beneficiary may discount its draft with a bank in its locale. Again relying on the beneficiary's virtual assurance of payment, this negotiating paying bank will pay the beneficiary and then indorse the beneficiary's draft and documents over to the issuing bank for reimbursement.⁵⁵ The independence principle guarantees this negotiating bank quick reimbursement free from any disputes involving the underlying sale of goods contract. Unless the independence principle kept the issuing bank's payment obligation abstracted from the underlying sales contract, parties such as the two banks in the above mentioned examples would not agree to participate in the letter of credit transaction in reliance on the proceeds owed to the beneficiary. Thus, the usefulness of the letter of credit mechanism would be harmed.

b. *Analogical Application of the Policies Underlying the Independence Principle*

The second step in analogical reasoning is to apply these policies to the new situation. Two of the aforementioned policies—protection of the beneficiary and protection of the letter of credit mechanism—support extending the independence principle to the facts of Example 4. By demanding a letter of credit, seller X seeks to protect himself from buyer Y's ability to delay payment. In Example 4, it is still buyer

54. In *Union Planters Nat'l Bank v. World Energy Sys. Assocs.*, 816 F.2d 1092 (6th Cir. 1987), the court discussed the practice whereby a bank which advises letter of credit number 1 will take an assignment of the proceeds of letter of credit number 1 as security for issuing letter of credit number 2 on behalf of the beneficiary. *Id.* at 1095. Sometimes, however, a beneficiary may simply assign the proceeds of the credit to the supplier without having a "back to back" credit issued. See U.C.C. § 5-116(2).

55. See the facts in *Supreme Merchandise Co. v. Chemical Bank*, 70 N.Y.2d 344, 514 N.E.2d 1358, 520 N.Y.S.2d 734 (1987), in which two banks had negotiated the beneficiary's drafts in Japan and then presented the drafts for acceptance by the issuing bank in New York.

Y who is seeking to delay payment. Similarly, without the independence principle, intermediary banks that might agree to participate in the letter of credit transaction relying on seller X's right to obtain payment under the credit would be harmed if buyer Y were allowed to attach the proceeds of the credit as in Example 4. This would obviously discourage intermediary banks from participating in letter of credit transactions, thereby damaging the usefulness of the letter of credit mechanism. The third policy underlying the independence principle—protection of the issuing bank—is not implicated by an attachment of letter of credit proceeds as in Example 4. Unlike an injunction, which prevents an issuing bank from paying the credit, an attachment allows the issuing bank to pay the proceeds of the credit over to an officer of the court.⁵⁶ Since the attachment permits the bank to pay the credit (although not to the beneficiary), the issuing bank need not become involved in the underlying dispute between the applicant and the beneficiary. Of course, since an attachment does block payment to the beneficiary, attaching the proceeds of a credit could conceivably result in harm to the assets of the issuing bank or at least harm to the issuing bank's financial standing in countries where the intricacies of American attachment law are not appreciated.⁵⁷

In Example 4, there do not appear to be strong countervailing considerations that argue against extending the independence principle. Given the facts of Example 4, protecting the buyer-applicant's interests is not a persuasive reason. First, by requesting the issuance of a letter of credit, the buyer-applicant asked the issuing bank to undertake an irrevocable commitment to pay the beneficiary. Except in the most exceptional of circumstances, the buyer-applicant should not be permitted to derogate from that request by seeking to vary what it asked the issuing bank to do—viz., pay the beneficiary.⁵⁸ Second, the buyer-applicant should not be able to use simple breach of contract disputes emanating from unrelated contracts to interrupt payment of a letter of credit. At least according to the majority view, UCC section 5-114(2) allows only "active" or "egregious" fraud in the underlying contract to interrupt payment of a letter of credit. A fortiori, it would seem that equivalent conduct must be shown if an unrelated contract is being used to interrupt payment of a credit.

There is little case law on the precise issue presented in Example 4 but the French *Cour de Cassation*—the Supreme Court of France—did address the issue in the case of *Société Bisch v. Société Façon Deutschland*.⁵⁹ The French Supreme Court quashed an attempted attachment by the applicant for the credit on the ground that such an attachment, even when based on an unrelated cause of action, was "contractually unavailable" to the applicant.⁶⁰ To quote the court: the applicant

56. See, e.g., N.Y. CIV. PRAC. L. & R. 6214(b), (c) (McKinney 1980).

57. See *American Bell Int'l, Inc. v. Islamic Republic of Iran*, 474 F. Supp. 420, 426 (S.D.N.Y. 1979).

58. See the opinion of the Master of the Rolls, Sir John Donaldson, in *Bolivinter Oil, S.A. v. Manhattan Bank*, [1984] 1 All E.R. 351, 352.

59. *Société Bisch v. Société Façon Deutschland*, Cass. civ. com. No. 86-16.737 (Mar. 18, 1986) (LEXIS, Prive library, Cassci file). For a discussion of the *Société Bisch* case, see Riggs, *Recent Developments in France in Documentary Credits and Bank Guarantees*, 14 Letter of Credit Seminar, London, Oct. 1987 (Executive Enterprises, Inc.). See also Riggs, *Autonomy of Documentary Credit*, LETTERS OF CREDIT REPORT, Jan. 1987, at 11-12.

60. See Riggs, *Autonomy of Documentary Credit*, *supra* note 59, at 11.

could not "for the purpose of preventing the performance of the obligation undertaken by the bank pursuant to his instructions, rely on the debt owed to him by the beneficiary even where such debt arose outside the underlying contract."⁶¹

Case law in the United States has generally supported the conclusion of the French Supreme Court in *Société Bisch*—although the American cases have not discussed the issue in the precise context of attachments based on unrelated claims. Several cases, however, have dealt with the analogous question of whether the applicant's setoff rights can reduce the beneficiary's recovery for wrongful dishonor of a letter of credit. For example, in *East Girard Savings Association v. Citizens National Bank*,⁶² the issuing bank argued that the ordinary contract measure of damages should be applied in wrongful dishonor suits brought by the beneficiary of a standby letter of credit.⁶³ The ordinary contract measure of damages would limit the beneficiary's recovery to actual losses caused by the wrongful dishonor. Actual losses caused by the wrongful dishonor, the bank argued, would constitute the full amount of the dishonored draft set off by any amounts the beneficiary owed the applicant arising out of their underlying agreements. If it were proper in a wrongful dishonor suit to reduce the beneficiary's recovery by amounts arising out of these underlying agreements between the beneficiary and the applicant, then arguably the independence principle might be breached in Example 4. The Fifth Circuit in *East Girard*, however, rejected any notion that the beneficiary's recovery for wrongful dishonor under Contract III could be affected by the general "status of contract affairs" between the beneficiary and the applicant.⁶⁴ The court emphasized that the independence principle was designed to protect the issuing bank from having to assess competing equities between the beneficiary and the applicant before it can pay the beneficiary's draft.⁶⁵

The same issue arose in *Temtex Products, Inc. v. Capital Bank & Trust Co.*⁶⁶ As in *East Girard*, the issuing bank in *Temtex* refused to honor its letter of credit. According to the issuing bank, the beneficiary and the applicant had "certain oral agreements for the payment of overriding royalties which allowed [the beneficiary] to apply credits to the amounts owed by [the applicant]."⁶⁷ Because the beneficiary "did not offset the invoice amounts with those credits, the drafts fraudulently

61. See Riggs, *Recent Developments in France in Documentary Credits and Bank Guarantees*, *supra* note 59, at 14 (citing *Société Bisch*, Cass. civ. com. No. 86-16.737 (Mar. 18, 1986)).

62. 593 F.2d 598 (5th Cir. 1979).

63. *Id.* at 603.

64. *Id.* at 603-04.

65. The Fifth Circuit in *East Girard* did not read U.C.C. § 5-115(1) as supporting the notion that the independence principle can be breached in wrongful dishonor suits. According to this section, the beneficiary's recovery for wrongful dishonor is essentially the face amount of the draft reduced by "any amount realized by resale or other disposition of the subject matter of the transaction." U.C.C. § 5-115(l). The Fifth Circuit did not feel that requiring the beneficiary to deduct the amount received on the resale of the goods in a commercial letter of credit case was inconsistent with the independence principle. The documents representing the goods are mentioned in the letter of credit itself. "Thus, since the goods resold are specifically mentioned in the letter of credit, the court need not look to the underlying contracts to determine which goods are involved." *East Girard Sav. Ass'n*, 593 F.2d at 604. In any event, the U.C.C. § 5-115(l) formula would not permit reductions based on unrelated transactions between the beneficiary and the applicant.

66. 623 F. Supp 816 (M.D. La. 1985), *aff'd*, 788 F.2d 1563 (5th Cir. 1986).

67. *Id.* at 821.

overstated the amounts due.”⁶⁸ Citing *East Girard*, the federal district court in *Temtex* summarily rejected the issuing bank’s argument. “The *East Girard* case . . . clearly states that a letter of credit is independent of any set-off which might be available under ordinary contract law and that the issuer has a duty to honor the drafts when accompanying documents are genuine and conforming.”⁶⁹ Although *East Girard* and *Temtex* do not deal precisely with the validity of applicant attachments based on unrelated claims, the cases do stand for the proposition that in determining whether or not to honor a letter of credit, the independence principle precludes the issuing bank from considering the general ledger of accounts between the beneficiary and the applicant.⁷⁰ If the issuing bank cannot consider the general ledger in defending against a wrongful dishonor action, the applicant should not be able to use an attachment as a vehicle for forcing unrelated claims into the letter of credit payment process.

2. Claim Brought by the Beneficiary Against the Applicant

Seller X, the beneficiary of First Bank’s irrevocable letter of credit, presents his draft and the requisite shipping documents to First Bank to obtain payment for the metal bolts. Immediately after First Bank honors the credit, seller X sues buyer Y, alleging a cause of action unrelated to the letter of credit, and attempts to attach the shipping documents representing the metal bolts. Seller X argues that an attachment would be appropriate in these circumstances because, after honor, the shipping documents constitute property of buyer Y and are thus subject to attachment in a seller X-buyer Y suit.

Although this is a less common situation than an attachment sought by the applicant,⁷¹ nonetheless the UCC provides a ready answer to the problem. Under UCC section 5-110(2), seller X’s attempted attachment should fail. According to this section, “a person by presenting a documentary draft or demand for payment under a credit relinquishes upon its honor all claims to the documents An explicit reservation of claim makes the draft or demand non-complying.”⁷² “All claims” seems to mean exactly what it says—all claims the beneficiary might have to the shipping documents whether those claims arise out of Contract I or out of some

68. *Id.*

69. *Id.* at 822.

70. *First Nat’l City Bank v. Banco Para El Comercio Exterior de Cuba*, 462 U.S. 611 (1983), however, may be inconsistent with this conclusion. In *First Nat’l City Bank*, the Supreme Court of the United States upheld an issuing bank’s right to set off unrelated claims against the amount claimed by the beneficiary under the letter of credit. Similarly, in *Bamberger Polymers Int’l Corp. v. Citibank*, 124 Misc. 2d 653, 477 N.Y.S.2d 931 (Sup. Ct. 1983), the New York court denied an advising and paying bank the right to set off amounts owed it by the beneficiary of the credit. The court in *Bamberger* suggested, however, that the result would have been different if the advising bank trying to exercise setoff had also confirmed the credit. One commentator has noted that precedents like that of *First Nat’l City Bank* and suggestions like those in *Bamberger* violate the independence principle of letter of credit law. See J. DOLAN, *supra* note 1, ¶ 9.06(3), at 9–43.

71. This issue was presented, however, to the Swiss Supreme Court in the case of *Union de Banques Suisses v. Finagrain*, Mar. 24, 1986, SJ 1986, 529 (Decision No. 3). For a discussion of this case, see Junod, *Attachment of Letter of Credit Documents*, LETTERS OF CREDIT REPORT, Jan. 1987, at 13–14. The Swiss Supreme Court, unlike the drafters of U.C.C. § 5-110(2), did allow the beneficiary to attach the documents tendered under the credit.

72. U.C.C. § 5-110(2).

unrelated contract between seller *X* and buyer *Y*. Although not phrased as such, UCC section 5-110(2) seems to represent a corollary of the independence principle—at least with respect to posthonor claims to letter of credit documents made by the beneficiary.

E. *Example 5—A Dispute Arising out of a Contract Between the Beneficiary and a Third Party Unrelated to the Letter of Credit*

Seller *X*, the beneficiary of First Bank's irrevocable letter of credit, presents his draft and the requisite shipping documents to First Bank to obtain payment for the metal bolts. The day after the beneficiary presents his draft and documents, however, creditor *P*, who is neither a party to the letter of credit transaction nor a party to the underlying sales contract regarding the metal bolts but who is separately owed money by seller *X*, brings suit against seller *X* and attempts to attach the proceeds of the letter of credit owed seller *X* by First Bank. As a third party creditor, creditor *P* seeks to treat the letter of credit proceeds as a routine asset of the beneficiary subject to the ordinary rules of attachment.

The analysis in Example 4 presumably demonstrated two things. First, the independence principle, at least as stated in both the UCC and the UCP, does not specifically protect the proceeds of the letter of credit from claims between the beneficiary and the applicant which do not arise directly out of the letter of credit transaction. Second, despite this, UCC section 5-102(3) will permit the independence principle to be extended analogically to "a situation not provided for [as was the case in Example 4] or to a person not specified by this Article."⁷³ Although article 5 of the UCC does not specifically extend the coverage of the independence principle to third party claims, after balancing the commercial policies discussed earlier in Example 4, the independence principle still should be extended to prohibit creditor *P*'s attempted attachment in Example 5.

In requesting a letter of credit, it is true that the beneficiary seeks protection from disputes with the applicant, not from disputes with unrelated third parties. If beneficiary protection were the only commercial or economic policy supporting the independence principle, then perhaps the independence principle should be breached in Example 5 and creditor *P*'s attachment permitted. But the independence principle also protects the interests of the issuing bank and the usefulness of the letter of credit mechanism. The cases that have dealt with the question of attachments by third party creditors have usually quashed these attachments on the ground that they would harm the letter of credit mechanism. In *Diakan Love, S.A. v. Al Haddad Bros.*,⁷⁴ for example, a third party creditor of the beneficiary sought to attach the proceeds of the letter of credit prior to the beneficiary's draw under the credit. The federal district court ruled that in this case the attachment was premature since there was no property of the beneficiary to be attached until after the beneficiary drew on the credit.⁷⁵ The

73. U.C.C. § 5-102(3).

74. 584 F. Supp. 782 (S.D.N.Y. 1984).

75. *Id.* at 784. See also *Union Planters Nat'l Bank v. World Energy Sys. Assocs.*, 816 F.2d 1092, 1097-98 (6th

court went on to emphasize, however, that even if the beneficiary had already drawn on the credit, it still would not have permitted the third party to attach the proceeds of the credit. Tolerating these attachments would only harm the letter of credit mechanism and its function as a lubricant in international trade. As the court pointed out, what bank would agree to issue a "back to back" letter of credit on the strength of the beneficiary's assignment of the proceeds of a prior letter of credit, if the bank knew that some unknown third party creditor of the beneficiary, such as creditor *P* in Example 5, could undermine the bank's security simply by attaching those proceeds?⁷⁶

In *Supreme Merchandise Co. v. Chemical Bank*,⁷⁷ the New York Court of Appeals, relying on the analysis in *Diakan Love*, reached the same conclusion—namely, that before the beneficiary presents the issuing bank with his draft and documents, the beneficiary's executory interest in the letter of credit constitutes neither a debt owed the beneficiary nor property of the beneficiary that is subject to attachment under New York law. Interestingly, however, the New York Court of Appeals also rested its decision on the alternative ground that the policy considerations underlying the use of letters of credit in international trade militate against allowing attachments of the proceeds of these credits.⁷⁸

As mentioned earlier, protection of the issuing bank—the third policy underlying the independence principle—does not weigh too heavily in attachment cases.⁷⁹ Unlike an injunction, an attachment does not prevent the issuing bank from honoring its payment obligation under the letter of credit.⁸⁰ Because it does, in fact, pay the credit (although not to the beneficiary), the bank does not become involved in the underlying dispute between creditor *P* and seller *X* and should not normally be harmed by the attachment. But, if due to the attachment, the issuing bank's assets or financial reputation in a foreign country were in danger of being harmed, then it would seem appropriate to add the interests of the issuing bank to the calculus in Example 5.⁸¹

At this point in the analysis, the balance seems to tilt in favor of extending the independence principle to prohibit third party attachments. But unlike the facts of Example 4, in which buyer *Y* (the applicant) was seeking the attachment, in Example 5, it is creditor *P*, a third party creditor, who is seeking the attachment. Creditor *P* is not a party to the original letter of credit transaction—he is not a party to Contract I, to Contract II, or to Contract III—and thus, the remedy of attachment is not "contractually unavailable" to him.⁸² Therefore, prohibiting the attachment of the

Cir. 1987); *Sisalcords do Brazil v. Fiacao Brasileira de Sisal, S.A.*, 450 F.2d 419 (5th Cir. 1971) (per curiam), *cert denied*, 406 U.S. 919 (1972).

76. *Diakan Love*, 584 F. Supp. at 785.

77. 70 N.Y.2d 344, 514 N.E.2d 1358, 520 N.Y.S.2d 734 (1987).

78. *Id.* at 351–52, 514 N.E.2d at 1361–62, 520 N.Y.S. 2d at 737–38. See also *Ferrostaal Metals Corp. v. S.S. Lash Pacifico*, 652 F. Supp. 420, 424–25 (S.D.N.Y. 1987). But see *Sabolyk v. Morgan Guar. Trust Co.*, No. 84 Civ. 3179, slip op. at 4 (S.D.N.Y. Nov. 27, 1984) (attachment does not chill commercial acceptance of a standby letter of credit).

79. See *supra* notes 56–57 and accompanying text.

80. See *supra* note 56.

81. See *supra* note 57.

82. See Riggs, *Autonomy of Documentary Credit*, *supra* note 59, at 11.

letter of credit proceeds in Example 5 hurts creditor *P*'s interests—interests which were never considered in the risk-responsibility allocation among the parties to the original letter of credit transaction.

But as a practical matter, creditor *P*'s interests would not be affected radically even if the independence principle were extended to prohibit creditor *P* from attaching the letter of credit proceeds. First, even if the proceeds were deemed to be attachable under letter of credit law, recent constitutional restrictions on quasi in rem actions⁸³ would limit the number of situations in which creditor *P* could validly attach letter of credit proceeds based on unrelated claims. Second, again assuming the proceeds were deemed to be attachable under letter of credit law, creditor *P* would be able to attach these proceeds only in the short period of time between the beneficiary's presentation of the draft (and documents) and the issuing bank's payment or acceptance of the draft—probably a period of no more than three days.⁸⁴ Thus, creditor *P*'s attachment would have to be pinpointed precisely in its timing—a not too easy task. Third, even if creditor *P* were sufficiently precise in the timing of the attachment, the documents and draft may have already been purchased in good faith by a negotiating or confirming bank with the result that the proceeds of the credit would no longer be property of the beneficiary subject to attachment.⁸⁵

Given the strong commercial policy favoring protection of the letter of credit mechanism and the relatively minor harm done to creditor *P*'s interests by denying him the right of attachment, it would seem, on balance, that the independence principle should be applied to insulate Contract III, the letter of credit contract, from all claims made by third parties that are unrelated to the original letter of credit transaction.

To be fair, however, this conclusion is controversial and predictably will not be accepted by everyone. Critics would point out that most types of payment obligations (choses in action) are subject to third party attachment even though the attachment may adversely affect innocent parties who rely on the payment obligation unaware of the attachment. If this is the rule with respect to payment obligations generally, these critics would argue that the same rule should be applied to letter of credit payment obligations as well. This position seems to have won over at least one important

83. See, e.g., *Shaffer v. Heitner*, 433 U.S. 186 (1977).

84. The UCC allows a bank issuer of a letter of credit to defer honor of the credit "until the close of the third banking day following receipt of the documents." U.C.C. § 5-112(l)(a). If the bank does not meet this deadline, it is considered to have dishonored the credit. Compare U.C.P. art. 16, which allows the issuing bank a "reasonable time" to examine the documents, after which failure to accept or return the documents precludes the bank from claiming that documents are not in accordance with the terms of the letter of credit.

85. U.C.C. § 5-114(2)(a) states that an issuing bank must honor a draft or demand for payment if honor is demanded by a negotiating bank that has taken the draft or demand for payment "under the credit" and under circumstances that would make it a holder in due course. It has been argued, however, that the conclusion that after negotiation, the draft and documents are no longer the property of the beneficiary may have to be qualified in cases where a bank negotiates the beneficiary's draft under a straight letter of credit. Since, under a straight letter of credit, the obligation of the issuing bank does not run directly to all banks that negotiate the beneficiary's draft, arguably the negotiating bank in this situation has no right to rely on the letter of credit obligation of the issuing bank and thus when it presents the draft and documents, it does so as agent of the beneficiary, not in its own right. See J. DOLAN, *supra* note 1, ¶ 8.02 (6). Thus, under these circumstances, the letter of credit proceeds may still be viewed as the beneficiary's property. On this general subject, see *Lantz Int'l Corp. v. Industria Termotecnica Campana, S.P.A.*, 358 F. Supp. 510 (E.D. Pa. 1973).

adherent—the French *Cour de Cassation* (the Supreme Court of France). In *Chase Manhattan Bank, N.A. v. Banque des Antilles Francaises*,⁸⁶ the French Supreme Court permitted a third party creditor to attach the letter of credit debt due from the issuing bank to the beneficiary.

To conclude Part II of this Article, it would seem that, by its own terms, the independence principle keeps the letter of credit contract (Contract III) separate from and independent of disputes arising out of Contract I and Contract II unless the dispute involves “egregious” or “active” fraud in Contract I. When one moves beyond the precise textual perimeters of the independence principle, however, extensions can be justified only if the extension is supported by a balancing of appropriate commercial and economic policy considerations. In cases where the applicant for the credit seeks to interrupt payment of the credit based on claims arising out of contracts unrelated to the letter of credit (Example 4) or in cases where an unrelated third party seeks to interrupt payment of the credit (Example 5), a balancing of these considerations supports extending the independence principle to protect the letter of credit mechanism.

III. APPLYING THE INDEPENDENCE PRINCIPLE TO ILLEGALITY IN THE UNDERLYING CONTRACT

Before applying the model of the independence principle and the fraud exception to illegality in the underlying contract, one distinction should be explained. The subsequent discussion focuses solely on illegality in the underlying contract (Contract I) that affects payment of the letter of credit (Contract III), not on the separate question of illegality in the letter of credit itself (Contract III).⁸⁷ The independence principle does not insulate a letter of credit from its own illegality. Occasionally, a letter of credit may be found to be illegal because the issuing bank violated applicable lending limits when it issued the credit,⁸⁸ or because the bank's payment of the credit might violate a governmental ban on payments to certain entities.⁸⁹ In one sense,

86. Cass. civ. com., No. 81-11.971 (July 5, 1983) (LEXIS, Prive library, Cassci file). For reference to this case, see Riggs, *Autonomy of Documentary Credit*, *supra* note 59 at 11. See also MacNaughton, *Seizure of a Letter of Credit in the People's Republic of China*, LETTERS OF CREDIT REPORT, Jan.-Feb. 1989 at 11, for the report of *China Nat'l Technical Import-Export Corp. v. Industrial Resources Corp.*, Hu Gao Jing Shang Zi No. 30 (Shanghai Municipal High People's Court, Oct. 11, 1988)—a case from the People's Republic of China which permitted a third party to freeze letter of credit proceeds owed to a named beneficiary for possible application in a dispute between the third party and a company related to the beneficiary of the credit.

87. In this Article, the word “illegality” is being used in the broad sense of any contravention of public policy. When the conduct being referred to is criminal, the words “criminal illegality” or words of similar import will be used. See E. FARNSWORTH, *THE LAW OF CONTRACTS* 327 (1982). The word “illegality,” although perhaps misleading in other contexts when used to cover all criminal and noncriminal contraventions of public policy, seems to be adequately descriptive for the purposes of this Article.

88. *International Dairy Queen, Inc. v. Bank of Wadley*, 407 F. Supp. 1270 (M.D. Ala. 1976). But see *City Nat'l Bank v. First Nat'l Bank & Trust Co.*, 22 Ark. App. 5, 732 S.W.2d 489 (1987); *First Am. Nat'l Bank v. Alcorn, Inc.*, 361 So. 2d 481 (Miss. 1978).

89. Occasionally a government acts by statute or by regulation and forbids an issuing bank to honor its credits under a given set of circumstances. If a bank were to violate these governmental restrictions, the letter of credit payment would be illegal under the applicable national law. During the 1979-80 Iranian crisis, for example, President Carter ordered U.S. bank issuers of letters of credit to pay all amounts due Iranian beneficiaries into blocked accounts. See 31

these issues involve the impact of illegality on letters of credit, but they do not require an analysis of the independence principle in order to resolve them.

Broadly speaking, illegality in the underlying contract (Contract I) can take several forms. The underlying contract may be illegal in the sense that performance of the contract will violate public policy as embodied in the common law, in a civil statute, or in a criminal statute. Obviously, the mechanism chosen by society to condemn conduct reflects how strongly society feels about that conduct. Criminalizing conduct is, of course, the strongest expression of societal condemnation.

Let us apply the model of the independence principle to each type of Contract I illegality.

A. Example 6—A Penalty Clause: Illegality Which Violates the Common Law

Buyer *Y* agrees to buy metal bolts from seller *X* for \$40,000. Buyer *Y*, however, needs the metal bolts by June 1, 1987. In order to soothe buyer *Y*'s fears of a late delivery, seller *X* agrees that if the bolts are not delivered by that date, seller *X* will pay buyer *Y* a \$10,000 penalty. To guarantee payment of the penalty, seller *X* (the applicant for the credit) asks First Bank (the issuing bank) to issue its irrevocable standby letter of credit obligating itself to pay buyer *Y* (the beneficiary) \$10,000 upon buyer *Y*'s presentation to First Bank of a draft for \$10,000 and a signed certificate attesting to seller *X*'s failure to deliver the bolts by June 1, 1987. Subsequent both to the signing of the sales contract with buyer *Y* and the issuance of First Bank's standby letter of credit, seller *X* learns that he can sell the bolts to buyer *Q* for \$43,000. Seller *X* proceeds to sell the bolts to buyer *Q* and fails to deliver the bolts to buyer *Y* by June 1, 1987. Buyer *Y* presents his \$10,000 draft and the requisite certificate of default to First Bank. Seller *X* now attempts to enjoin First Bank from paying the credit on the ground that First Bank's payment of \$10,000 would enforce an illegal penalty.⁹⁰ According to seller *X*, buyer *Y* could purchase substitute metal bolts in the marketplace for \$41,000 and thus should recover damages of only \$1000, not \$10,000.

Penalty clauses have been characterized as "illegal" in several letter of credit cases.⁹¹ Penalty clauses are illegal in the sense that they do not represent a reasonable

C.F.R. § 535.201 (1987); 31 C.F.R. § 535.568 (1987). In *J. Zeevi & Sons v. Grindlays Bank (Uganda) Ltd.*, 37 N.Y.2d 220, 333 N.E.2d 168, 371 N.Y.S.2d 892, *cert. denied*, 423 U.S. 866 (1975), the Government of Uganda, through the discriminatory application of Uganda's exchange control laws, essentially forbade a Ugandan bank issuer of a letter of credit to pay Israeli beneficiaries. In *Sound of Market Street, Inc. v. Continental Bank Int'l*, 819 F.2d 384 (3d Cir. 1987), *reh'g denied*, (June 15, 1987), bank counsel suspected at one point that a clause in a letter of credit could potentially represent a boycott clause which might have violated federal antiboycott regulations. Bank counsel, however, later opined that the clause did not violate the applicable antiboycott regulations. *Id.* at 386. For a discussion of U.S. antiboycott regulations, see Hall, *The Effect of the U.S. Antiboycott Regulations on Letters of Credit*, LETTERS OF CREDIT REPORT, Nov.-Dec. 1988, at 1.

90. In *Brown v. United States Nat'l Bank*, 220 Neb. 684, 371 N.W.2d 692 (1985), the applicant for the credit tried to reform the amount of an outstanding letter of credit as an alternative to bringing an injunctive action. Based on the independence principle, however, the Supreme Court of Nebraska rejected the applicant's attempt at reformation. *Id.* at 699, 371 N.W.2d at 701. Thus, if instead of seeking an injunction, seller *X* had tried to reform the amount of the credit from \$10,000 to \$1000, seller *X*'s attempt should also have been unsuccessful.

91. See *infra* cases cited at notes 94, 96.

pre-estimate of buyer *Y*'s damages.⁹² For example, at the time of the signing of the contract, buyer *Y* may have known that if the bolts were not delivered by June 1, 1987, he could buy substitute bolts for \$41,000. Thus, if the penalty clause were enforced, buyer *Y* would be overcompensated by \$9000, and overcompensation violates the philosophy of damages in common law contract actions. Damages for breach of contract should put a party in as good a position as performance but not in a better position than performance.⁹³

When applicants for letters of credit have tried to enjoin payment based on the presence of an illegal penalty clause in Contract I, courts have consistently refused to grant the injunctions, citing the independence principle. The leading case on this question is *New York Life Insurance Co. v. Hartford National Bank & Trust Co.*⁹⁴ According to the Supreme Court of Connecticut:

[T]he question of whether this . . . liquidated damages clause was a penalty [was a claim] relating to the mortgage loan commitment contract between [applicant and beneficiary] which, as discussed previously, was entirely separate and independent from the letter of credit arrangement involving [issuer and beneficiary]. In the present case, these allegations were not proper defenses to the issuer's obligations to honor the draft pursuant to the letter of credit.⁹⁵

The same result was reached by a Minnesota federal district court in *Prudential Insurance Co. of America v. Marquette National Bank*.⁹⁶ In *Prudential*, a standby letter of credit was issued in favor of the plaintiff Prudential Insurance Company by defendant Marquette National Bank. The standby letter of credit served as a loan commitment fee. If the applicant for the credit failed to take out the loan, the plaintiff insurance company, as beneficiary, could present the issuing bank with its draft for \$62,000 and the necessary documentation required by the credit. But when the plaintiff presented its draft and the necessary documentation, the issuing bank refused to pay, claiming that the \$62,000 loan commitment fee constituted an illegal penalty.⁹⁷ Like the Supreme Court of Connecticut in *New York Life Insurance*, however, the federal district court made short shrift of this argument. The court ruled that "the contract of [the applicant] with plaintiff is independent of the obligations of defendant as issuer of the letter of credit and that the alleged illegality of the

92. See J. CALAMARI & J. PERILLO, *THE LAW OF CONTRACTS* 640-41 (3d ed. 1987) for the distinction between an unenforceable (illegal) penalty clause and an enforceable liquidated damages clause.

93. This is the remedial philosophy of the UCC generally and article 2 of the UCC (the sales article) more specifically. See U.C.C. § 1-106(1). See also J. CALAMARI & J. PERILLO, *supra* note 92, at 591.

94. 173 Conn. 492, 378 A.2d 562 (1977).

95. *Id.* at 502, 378 A.2d at 567. A standby letter of credit payment was also upheld against attack that it was an illegal penalty in *Shel-Al Corp. v. American Nat'l Ins. Co.*, 492 F.2d 87, 93-96 (5th Cir. 1974). In upholding the alleged illegal payment, however, the court did not rely on the independence principle; rather it found that the amount of the credit and a cash deposit (which together constituted a standby deposit fee to guarantee that the applicant would take out mortgage financing) constituted valid liquidated damages. Similarly, a standby letter of credit secured the payment of penalty provisions in a cable television franchise agreement in *Tribune-United Cable v. Montgomery County*, 784 F.2d 1227 (4th Cir. 1986). The Fourth Circuit, however, did not discuss whether the presence of the alleged penalty would affect the validity of the letter of credit payment.

96. 419 F. Supp. 734 (D. Minn. 1976).

97. *Id.* at 736.

commitment standby fee is not a defense which may be asserted by defendant in this action."⁹⁸

As construed by these courts, the independence principle forbids an issuing bank from judging the validity of its payment obligation in terms of the underlying contract. In Example 6, the \$10,000 letter of credit payment can only be deemed to be a penalty if it was an unreasonably excessive pre-estimate of the damages buyer *Y* would suffer due to seller *X*'s delayed delivery of the bolts. This all relates to Contract I, the underlying sales contract. Judged solely from the perspective of Contract III, however, the \$10,000 standby letter of credit payment from First Bank to buyer *Y* is neutral. The \$10,000 is neither an invalid penalty, nor valid liquidated damages. It is simply a payment of \$10,000. This conclusion might be challenged on several grounds, however.

1. UCC Section 5-102(3)

If UCC section 5-102(3) can be used to extend the perimeters of the independence principle, why cannot the section also be used to extend the perimeters of the UCC section 5-114(2) fraud exception? By such reasoning, illegality—even common law illegality—could be deemed to be sufficiently analogous to “active” or “egregious” fraud so as to merit breaching the independence principle.

This argument, however, has little to recommend it. In cases of egregious fraud perpetrated by the beneficiary, an injunction may be merited because the applicant for the credit receives nothing in return for the letter of credit payment and cannot adequately protect himself from the beneficiary's fraud. This is not the case with a penalty clause, however. In cases where a standby letter of credit guarantees payment of an alleged penalty, the applicant for the credit will frequently be able to protect himself by persuading the beneficiary not to draw on the letter of credit. For example, in Example 6, seller *X* promised to deliver metal bolts to buyer *Y* by June 1, 1987 at a price of \$40,000. Seller *X* also agreed that if he failed to deliver the bolts by that date, he would pay buyer *Y* \$10,000 through First Bank's standby letter of credit. Assume, however, that seller *X* now learns that he can sell the bolts to buyer *Q* for \$43,000. Seller *X* realizes, however, that if he makes this sale, he will not be able to deliver bolts to buyer *Y* by June 1, 1987. Given these facts, the natural course of conduct for seller *X* would be to “bribe” buyer *Y* (the beneficiary of the standby credit) not to draw on the letter of credit. Prior to June 1, 1987, seller *X* could approach buyer *Y* with an offer to *either* deliver the bolts to buyer *Y* by June 1, 1987 *or* not deliver the bolts and split with buyer *Y* the \$3000 profit earned on the sale of the bolts to buyer *Q*. If buyer *Y* chooses the first alternative and demands delivery of the bolts by June 1, 1987, buyer *Y* will end up with bolts at a price of \$40,000. If buyer *Y* chooses the second alternative, however, buyer *Y* will end up with bolts at a price of \$41,000 (perhaps also by June 1, 1987) and a cash payment for some additional amount of money—let us say \$1500 (1/2 of the \$3000 profit earned by

98. *Id.*

seller *X* on the buyer *Q* sale). Assuming buyer *Y* is a profit-maximizer, buyer *Y* will probably choose the second alternative—particularly if he can also acquire the substitute bolts by June 1, 1987—because it leaves him \$500 richer. Thus, buyer *Y* will allow seller *X* to breach the contract and in return for the \$1500 payment buyer *Y* will not draw on the letter of credit.⁹⁹ If buyer *Y* takes the \$1500 and still attempts to draw on the letter of credit, seller *X* would most likely be in a position to seek an injunction based on fraud.¹⁰⁰

2. *Illegality—Even Common Law Illegality—Implicates the Rights of Society as a Whole*

According to this argument, any type of illegality in Contract I—even common law illegality—should not be treated as the equivalent of an ordinary contract dispute in Contract I. When conduct is deemed to be illegal, society has an interest that must be protected. Thus, when there is illegality in the underlying contract, the relevant analogy from Part II is Example 5, not Example 1. Since illegality in Contract I implicates the rights of society as a whole, these third party rights are much stronger than the rights of creditor *P* in Example 5 and should be enough to tilt the balance in favor of interrupting payment of the letter of credit.

The analogy to Example 5 is correct, but only up to a point. When there is an illegal penalty clause inserted in the underlying sales contract, the result is really a hybrid transaction, which combines elements of both Examples 1 and 5. The transaction involves a dispute not only between the beneficiary and the applicant for the credit (Example 1), but also a dispute that involves the rights of a third party—society (Example 5). As discussed earlier, the facts of Example 5 did not fit within the expressed perimeters of the UCC sections 5-109(1) and 5-114(1) independence principle. Thus, a balancing test had to be applied to determine whether or not to extend the independence principle. If this same balancing test were applied in Example 6, it is the author's opinion that the balance would again tilt decidedly in favor of extending the independence principle.

First of all, boiled down to its essentials, a dispute over a penalty clause is really a dispute over the size of the damages award. While it is true that the rules of contract damages are aimed at compensating, not overcompensating, the aggrieved party,¹⁰¹ still the prohibition against overcompensation is far from absolute. There are various situations when the common law permits overcompensation,¹⁰² and there is authority for the proposition that, assuming there is no unconscionability or duress involved in the transaction, the enforcement of penalty clauses will not necessarily produce

99. For a fuller development of this argument, see McLaughlin, *Standby Letters of Credit and Penalty Clauses: An Unexpected Synergy*, 43 OHIO ST. L.J. 1, 23–26 (1982).

100. See, e.g., *Roman Ceramics Corp. v. Peoples Nat'l Bank*, 714 F.2d 1207 (3d Cir. 1983).

101. See, e.g., D. DOBBS, *REMEDIES* § 12.1 (1973).

102. For example, in mortgage finance contracts, courts have sustained the validity of standby deposit provisions even when the amount of these deposits constituted more than a reasonable pre-estimate of future losses. See *Shel-Al Corp. v. American Nat'l Ins. Co.*, 492 F.2d 87, 95 (5th Cir. 1974). Similarly, in land sale contracts, judges often deny a defaulting vendee the return of a prepaid deposit even though the vendor is overcompensated by keeping the deposit. See C. MCCORMICK, *HANDBOOK ON THE LAW OF DAMAGES* 615–16 (1935).

economically inefficient results.¹⁰³ It seems safe to say that penalty clauses are "illegal" only in the loosest sense of that term. Thus, the third party interest at stake in Example 6 is weak and merits little protection.

Second, allowing illegality of this sort to breach the independence principle would create economically inefficient results. Issuing banks would be forced to determine whether the amount to be paid under a letter of credit represented a reasonable pre-estimate of the beneficiary's damages at the time of the signing of the underlying sales contract. This would require the issuing bank to expend resources assessing the market for metal bolts when the parties signed the sales contract—a task better left to merchants than to bankers.

B. Example 7—A Preferential Transfer: Illegality Which Violates a Civil Statute

Upon delivery of the metal bolts, buyer *Y* gives seller *X* a check for the full purchase price of \$40,000. Buyer *Y*'s check, however, is returned dishonored. Seller *X* decides to bring a replevin action for the return of the bolts. To forestall the replevin action, buyer *Y* agrees to pay seller *X* \$40,000 ninety days later and asks First Bank to issue an irrevocable standby letter of credit guaranteeing payment to seller *X* in the event of buyer *Y*'s default. Buyer *Y* in turn gives First Bank a certificate of deposit to secure reimbursement in the event First Bank has to honor its payment obligation under the credit. Unfortunately, buyer *Y* defaults on its payment obligation to seller *X*, and, as one would expect, seller *X* draws on First Bank's letter of credit. Ten days after seller *X* receives payment under the letter of credit, buyer *Y* files for bankruptcy. Buyer *Y*'s trustee in bankruptcy seeks to avoid the letter of credit payment to seller *X* as a preferential transfer violative of section 547 of the Bankruptcy Code.¹⁰⁴

A transfer of the debtor's property to or for the benefit of a creditor on account of an antecedent debt made within ninety days of bankruptcy that results in the creditor receiving more than he would receive in a liquidation will normally be avoidable by the trustee in bankruptcy as an illegal preferential transfer.¹⁰⁵ Such a transfer could be considered illegal in the sense that it violates a civil statute of the United States—section 547(b) of the Bankruptcy Code.

As with the penalty clause discussed in Example 6, the \$40,000 paid by First Bank to seller *X* in Example 7 can be deemed to be "illegal" only if it is judged in terms of Contract I. It cannot be deemed to be an illegal preference if it is judged simply as a \$40,000 payment made by a solvent issuing bank to the beneficiary. If the issuing bank's payment obligation under Contract III is treated as separate from and independent of the applicant's payment obligation to the beneficiary under Contract I, then the money used to pay the beneficiary-seller should be treated as

103. See Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 544 (1977).

104. The facts of Example 7 are based loosely on the facts of *In re Air Conditioning of Stuart, Inc.*, 72 Bankr. 657 (S.D. Fla. 1987), *aff'd in part and rev'd in part*, 845 F.2d 293 (11th Cir. 1988).

105. See 11 U.S.C. § 547(b), (f) (1982 & Supp. 1986) for the elements of a preferential transfer. Exceptions are listed in 11 U.S.C. § 547(c) (1982 & Supp. 1986).

property of the solvent issuing bank, not as property of the bankrupt-applicant.¹⁰⁶ If so, it would be impossible for the trustee to recapture the \$40,000 paid to seller X because a preferential transfer requires a transfer of the debtor's property. The only course open to the trustee would be to seek the return of the certificate of deposit transferred to the issuing bank as security for issuing its standby credit. But if the issuing bank had perfected its security interest in the certificate of deposit contemporaneously with its issuance of the standby credit, the trustee most likely would not be able to recapture the certificate of deposit.¹⁰⁷

It would seem then that if the independence principle were applied to the facts of Example 7, a letter of credit would execute a preferential transfer in violation of section 547 of the Bankruptcy Code. Given this, it might be justified to breach the independence principle in Example 7 and allow the illegality in Contract I to interrupt payment of the credit.

Fortunately, however, there is a third alternative—a way to apply the independence principle, thereby permitting the issuing bank to honor the letter of credit and still satisfy the Bankruptcy Code's policy against preferential transfers. The third approach was first developed by a federal district court in the case of *In re Air Conditioning of Stuart, Inc.*¹⁰⁸ and was later followed by the Fifth Circuit in the case of *In re Compton Corp.*¹⁰⁹

In *Air Conditioning of Stuart*, the debtor-applicant requested the issuing bank to issue a standby letter of credit in favor of Leasing Services Corporation to guarantee payment of an antecedent debt.¹¹⁰ Debtor Air Conditioning of Stuart gave the issuing bank its promissory note for the amount of the credit and assigned the issuing bank a certificate of deposit to collateralize payment of the note in the event that the issuing bank's letter of credit was ever called.¹¹¹ Unfortunately, one month after the debtor had assigned the certificate of deposit to the issuing bank, Air Conditioning of Stuart filed for bankruptcy. The issuing bank then sought a court declaration as to whether it could properly pay the proceeds of the credit to beneficiary Leasing Services Corporation. Air Conditioning of Stuart's trustee intervened in the action, claiming that the proceeds of the credit should be turned over to the trustee. Disregarding the independence principle, the bankruptcy court (the court of first instance in this litigation) nullified the issuing bank's letter of credit and ordered the issuing bank to

106. The vast majority of courts which have considered this issue have held that the bank's letter of credit payment is not property of the debtor for the purposes of the Bankruptcy Code. See, e.g., *In re Guy C. Long, Inc.*, 74 Bankr. 939 (E.D. Pa. 1987) and cases cited therein; *In re Page*, 18 Bankr. 713, 715-16 (D.D.C. 1982). But see *In re Twist Cap, Inc.*, 1 Bankr. 284 (D. Fla. 1979).

107. A trustee's "strong arm" power, 11 U.S.C. § 544 (1982 & Supp. 1986), is cut off by a perfected security interest. See U.C.C. § 9-301(1)(b), (3). Under 11 U.S.C. § 547(c)(1) (1982), the trustee's power to avoid a preferential transfer would be ineffective if the transfer of the property of the debtor (in this case the transfer of the security interest in the debtor's certificate of deposit) to the issuing bank was intended to be a contemporaneous exchange and was in fact a substantially contemporaneous exchange for the issuance of the letter of credit on behalf of the debtor.

108. 72 Bankr. 657 (S.D. Fla. 1987), *aff'd in part and rev'd in part*, 845 F.2d 293 (11th Cir. 1988).

109. 831 F.2d 586 (5th Cir. 1987), *reh'g granted*, 835 F.2d 584 (1988).

110. *Air Conditioning of Stuart*, 72 Bankr. at 658-59. The court emphasized this point when it noted that "the debt owed by [the applicant for the credit] to [the beneficiary] existed prior to the issuance of the letter of credit." *Id.* at 660.

111. *Id.* at 658-59.

return the note and certificate of deposit to the trustee.¹¹² The bankruptcy court's nullification of the credit was based on the fact that the opening of the letter of credit and the transfer of the note and the certificate of deposit were all part of a "single contemporaneous transaction," which would have resulted in a preferential transfer of debtor's assets to the unsecured creditor-beneficiary.¹¹³

On appeal, both the federal district court and the Eleventh Circuit agreed with the bankruptcy court's ultimate result, but strongly disagreed with the means used by the bankruptcy court in reaching that result—particularly the bankruptcy court's nullification of the letter of credit.¹¹⁴ The district court and the Eleventh Circuit realized that if the preferential character of the applicant-beneficiary payment could block the bank's payment obligation, then events in Contract I were in fact affecting Contract III. This would violate the independence principle. Alternatively, however, both courts realized that if they applied the independence principle, then the letter of credit would execute a preferential payment to Leasing Services Corporation in violation of section 547 of the Bankruptcy Code. Under the facts of the case, it was also clear that the trustee would not be able to recover the certificate of deposit from the issuing bank because the issuing bank had perfected a security interest in the certificate that was seemingly immune from trustee challenge.¹¹⁵

Section 550(a)(1) of the Bankruptcy Code provided the third way needed to resolve this dilemma. Section 550(a)(1) allows the trustee, *inter alia*, to recapture "the value" of the property transferred out of the bankrupt's estate (the certificate of deposit) from "the entity for whose benefit the transfer was made" (beneficiary Leasing Services Corporation).¹¹⁶ Thus, by using section 550(a)(1), the federal district court and the Eleventh Circuit could (i) allow the letter of credit to be paid to the beneficiary, thereby preserving the independence principle, (ii) allow the issuing bank to keep the certificate of deposit, thereby preserving the bank's perfected security interest in the collateral, and (iii) allow the trustee to recapture the value of the certificate of deposit from the creditor-beneficiary for whose benefit the transfer of the certificate of deposit had been made, thereby preserving bankruptcy policy.¹¹⁷

In *In re Compton Corp.*,¹¹⁸ the Fifth Circuit faced a situation quite similar to that in *In re Air Conditioning of Stuart*. Creditor Blue Quail Energy, Inc. (Blue Quail) had delivered oil to debtor Compton Corp. (Compton). When it failed to make timely payment for the oil, Compton asked MBank to issue a standby letter of credit in Blue Quail's favor to guarantee payment for the oil. MBank issued the letter of credit and secured its payment obligation under an existing collateral arrangement with

112. *In re Air Conditioning of Stuart, Inc.*, 55 Bankr. 157, 160 (Bankr. S.D. Fla. 1985).

113. *Id.* at 159.

114. *Air Conditioning of Stuart*, 72 Bankr. at 657, *aff'd in part and rev'd in part*, 845 F.2d 293 (11th Cir. 1988).

115. In *Air Conditioning of Stuart*, the bankruptcy court found that the issuance of the letter of credit on June 15 and the transfer of the collateral on June 21 were both part of a single contemporaneous transaction. 55 Bankr. at 159. Under 11 U.S.C. § 547(c)(1) (1982), this finding would seem to insulate the transfer of the certificate of deposit to the issuing bank from preference attack by the trustee.

116. 11 U.S.C. § 550(a)(1) (1982).

117. *Air Conditioning of Stuart*, 72 Bankr. at 662, *aff'd in part and rev'd in part*, 845 F.2d 293 (11th Cir. 1988).

118. 831 F.2d 586 (5th Cir. 1987), *reh'g granted*, 835 F.2d 584 (1988).

Compton.¹¹⁹ The day after the letter of credit was issued, however, an involuntary bankruptcy petition was filed against Compton.¹²⁰ Blue Quail then drew on the credit. The issuing bank paid the credit and was reimbursed from the collateral securing its letter of credit obligation. Ultimately, however, Compton's trustee sued Blue Quail to recapture the money paid to Blue Quail as a preferential transfer.

Adopting a direct/indirect transfer analysis, the Fifth Circuit ruled that the trustee could recover the money from Blue Quail because the payment did in fact constitute a preferential transfer. The Fifth Circuit agreed with the Eleventh Circuit in *Air Conditioning of Stuart* that a bank's letter of credit payment could not constitute a preference since it was a transfer of the bank's property, not the debtor's property as required by 11 U.S.C. section 547(b).¹²¹ But the direct transfer of collateral to the issuing bank to secure reimbursement of the letter of credit payment also benefitted Blue Quail.¹²² Without the transfer of the collateral, the issuing bank would not have issued the standby letter of credit in Blue Quail's favor. Thus, although the direct transfer of the debtor's property was to the issuing bank, it also constituted an indirect transfer for the benefit of creditor Blue Quail. As we have seen previously, under section 550(a)(1) of the Bankruptcy Code, the trustee was entitled to recover the value of the property transferred out of the debtor's estate to the issuing bank from Blue Quail, the creditor for whose benefit the transfer was made.¹²³

Cases such as *Air Conditioning of Stuart* and *Compton* support the notion that when a state or federal civil statute prohibits the payment of money, this illegality should not necessarily affect the independence of the letter of credit.¹²⁴ But these

119. *Id.* at 589. The Fifth Circuit recognized that the transfer of the collateral to MBank was not itself a preferential transfer under section 547(c)(1) of the Bankruptcy Code. *Id.* at 594.

120. *Id.* at 594.

121. *Id.* at 590, 595.

122. *Id.* at 594.

123. *Id.* at 595.

124. Several other cases have dealt with letter of credit transfers which seemed to violate either a federal or a state civil statute. In *Berman v. Le Beau Inter-America, Inc.*, 509 F. Supp. 156 (S.D.N.Y. 1981), *aff'd*, 697 F.2d 872 (2d Cir. 1981), the issuing bank had issued letters of credit to the beneficiary. At the time the letters of credit were issued, no security had been provided to the issuing bank. The trustee of the debtor-applicant for the credit claimed that a subsequent transfer of the debtor's funds to the issuing bank to collateralize the letters of credit constituted a fraudulent conveyance violative of both the Bankruptcy Act and New York debtor and creditor law and the payment of a dividend in violation of the New York Business Corporation Law. On the fraudulent conveyance issue, the court stated that even if the conveyance from the applicant to the issuing bank to collateralize the letters of credit constituted a fraudulent conveyance under federal or state law, the beneficiary did not receive its payment of money directly from the fraudulent conveyance. The issuing bank under the independence principle already owed an irrevocable obligation to pay the beneficiary under the letters of credit, which obligation antedated the transfer of the collateral. *Id.* at 161.

In *In re Originalia Petroleum Corp.*, 39 Bankr. 1003 (Bankr. N.D. Tex. 1984), the applicant tried to enjoin payment of a letter of credit on the ground that the payment to redeem stock would constitute a fraudulent conveyance and an "illegal contract" under Texas law. Citing the *Berman* case, the Texas bankruptcy court ruled that the proceeds of the letter of credit were property of the bank, not the bankrupt, and hence the letter of credit payment could not constitute a fraudulent conveyance. *Id.* at 1014. As for whether the redemption of stock through a letter of credit payment constituted an "illegal contract" under Texas law, the court ruled that the redemption of the stock was not illegal. Furthermore the court ruled that because of certain representations and warranties made by the applicant that the redemption agreement "would not violate any requirement of law, [the applicant] should not be permitted to now claim the transaction was illegal." *Id.* at 1013.

Brown v. United States Nat'l Bank, 220 Neb. 684, 371 N.W.2d 692 (1985), however, could be read to suggest that if the beneficiary of the credit is involved in some violation of law with respect to the underlying contract, the bank's letter of credit payment may be affected. In *Brown*, the court ruled that since the beneficiary of the letter of credit was involved neither in the making of alleged fraudulent misrepresentations in a private placement memo nor in any alleged failure to

cases also demonstrate that once a letter of credit has been paid, the independence principle no longer immunizes the proceeds of the credit from subsequent legal process. Since, in both of the aforementioned cases, there had been preferential transfers made to unsecured creditors, section 550(a)(1) provided a statutory basis to recover the value of the collateral transferred out of the bankrupt's estate from these unsecured creditors without undoing the actual letter of credit payments. Thus, the letters of credit in both *Air Conditioning of Stuart* and *Compton* could execute preferential transfers but could not legalize them.¹²⁵

Keeping the letter of credit payment insulated from preference issues makes good commercial and economic sense. If letter of credit payments could be treated as preferential transfers, issuing banks would be forced to check whether their payments were being used to repay antecedent debts and whether their payments were leaving beneficiaries better off than in a liquidation. These are notoriously difficult issues, the resolution of which would be costly and time consuming for issuing banks.

But one caveat should be mentioned here. The Bankruptcy Code outlaws preferential transfers to some creditors of the bankrupt in order to protect other creditors. In Example 6 (the penalty clause example) society's interest in interrupting payment of letters of credit may have been weak because the immediate parties to the contract were the only parties affected by the penalty payment. In Example 7, however, society's interest is stronger. Allowing a preference to be paid would affect more than the immediate parties to the underlying transaction; it would affect the other unsecured creditors of the bankrupt. But, because restitution of the value of the letter of credit payment was available under section 550(a)(1) of the Bankruptcy Code, applying the independence principle to keep the letter of credit separate from the preference issue did not harm these other creditors or society's interest.

But suppose in a different case involving payments prohibited by a civil statute, there was no rule of law allowing restitution of the letter of credit payments. For example, as one commentator has noted: "[c]ourts generally do not grant restitution under agreements that are unenforceable on grounds of public policy."¹²⁶ With respect to these contracts, courts usually leave the parties where they find them, in essence permitting the obligee to keep any illegal payments made by the obligor. Thus, if Contract I involved the making of payments which were prohibited by a civil statute, this "non-restitution" principle would seemingly prohibit a court from ordering the return of the issuing bank's Contract III payment from the beneficiary. Consequently, society's interest in curtailing the conduct prohibited by the civil statute might be thwarted because the beneficiary would be permitted to keep the "illegal" payment.

comply with the securities laws, the bank's letter of credit engagement should be kept independent of the alleged fraud and illegality. The court's reasoning, however, may suggest that illegality in the underlying contract would have affected the bank's payment obligation if the beneficiary had been involved in the illegality either by direct participation or by subsequent ratification. *Id.* at 699-700.

125. For differing analyses of the *Air Conditioning of Stuart* case, see generally McLaughlin & Cohen, *Commercial Law*, 196 N.Y.L.J., Sept. 22, 1986, at 1; Gross & Borowitz, *A New Twist on Twist Cap: Invalidating a Preferential Letter of Credit in In Re Air Conditioning*, 103 BANKING L.J. 368 (1986).

126. E. FARNSWORTH, *supra* note 87, at 363.

Luckily, the principle that courts will not grant restitution of any payments made under a contract that is unenforceable as against public policy is not absolute. Several exceptions to this principle exist; these exceptions give courts sufficient flexibility to protect society's interests whenever necessary. For example, restitution will be permitted if one of the parties has indicated that he has withdrawn from the illegal contract (the so-called "locus poenitentiae" exception).¹²⁷ Thus, if the applicant breaks off dealing with the beneficiary with respect to the performance of Contract I (the illegal contract) prior to the beneficiary's draw under the letter of credit, a court may consider this to be a sufficient withdrawal from the transaction to allow restitution of the letter of credit proceeds. To benefit from this "locus poenitentiae" exception, however, the applicant must present clear and convincing evidence that he withdrew from the illegal contract *before* the letter of credit was paid, not *after* it was paid. Evidence of withdrawal after payment of the credit would be questionable in light of the purpose of the "locus poenitentiae" exception which is to encourage withdrawal before the illegal purpose of the contract has been achieved.

Similarly, restitution will be granted if the amount of the forfeiture is not commensurate with the public policy violated.¹²⁸ Thus, the court's willingness either to grant or to deny restitution of all or part of the proceeds of the letter of credit can be directly linked to the contravention of public policy involved in Contract I. If restitution of the proceeds of the credit would better serve society's public policy goals, then restitution can be allowed under this exception.

C. *Example 8—Commercial Bribery: Illegality Which Violates a Criminal Statute and Would Expose the Issuer to Criminal Liability for Paying the Credit*

Five persons bid to obtain a sales contract from buyer *Y*. Seller *X* wins the sales contract by promising buyer *Y*'s purchasing agent a bribe upon completion of the sale. Seller *X* builds the amount of the bribe into the sales price of the metal bolts and requests buyer *Y* to have First Bank issue a letter of credit for this inflated sales price. It is assumed that commercial bribery violates a criminal statute of State *M* where buyer *Y*, buyer *Y*'s purchasing agent, and First Bank are all located.¹²⁹ When seller *X* presents his draft and accompanying documents to obtain payment under the letter of credit, buyer *Y*, who has subsequently learned that his purchasing agent is to receive a bribe, requests First Bank to refuse payment of the credit because part of the letter of credit payment will be used to pay the criminal bribe. First Bank agrees not to pay the credit. Seller *X* sues First Bank in State *M* for wrongful dishonor of the credit.

There is virtually no U.S. case law on whether the independence principle should insulate a letter of credit from the effects of criminal conduct in Contract I.¹³⁰

127. For a discussion of this "locus poenitentiae" exception, see *id.* at 366–67.

128. *Id.* at 364.

129. Commercial bribery is a felony, for example, in various U.S. jurisdictions. See, e.g., N.Y. PENAL LAW §§ 180, 180.03 (McKinney 1975 & Supp. 1987). In New York if the value of the bribe exceeds \$1000 and certain other conditions are satisfied, the offense is a class E felony. *Id.* See also N.Y. PENAL LAW §§ 180.05, 180.08 (McKinney 1975 & Supp. 1987) (commercial bribe receiving).

130. The few American court decisions which have even alluded to the issue of whether illegality in Contract I can

It seems, however, in a case such as Example 8 in which the criminal illegality in Contract I will expose the issuing bank to criminal penalties for honoring its credit, the balance of policy factors tilts *against* extending the independence principle to insulate the credit from the criminal illegality in Contract I.

1. *Protection of the Beneficiary*

Given the beneficiary's illegal purpose in claiming payment under the letter of credit, beneficiary protection should receive little weight in assessing whether or not to breach the independence principle in a case such as Example 8.

2. *Protection of the Issuing Bank*

Because of the possible criminal sanctions that may be imposed on First Bank by State *M*, the interests of the issuing bank are best served by refusing to extend the independence principle to cover the facts of Example 8. A bank in State *M*, or an individual officer of a bank in State *M*, who pays a letter of credit after being informed that part of the letter of credit payment will be used to pay a criminal bribe in State *M* may be found to be an accessory to paying the bribe and suffer resulting criminal penalties. Recently, law enforcement agencies have aggressively prosecuted banks and individual bank officers for participating in illegal banking activities.¹³¹ Thus, to avoid possible charges of involvement in criminal activities, it seems preferable from the issuing bank's perspective to be allowed to refuse payment of one of its credits whenever the bank is presented with convincing evidence of criminal illegality in the underlying transaction. Alternatively, requiring the issuing bank to pay the legal portion of the credit but not to pay the illegal portion of the credit may make logical sense,¹³² but it would prove unworkable in practice. Under this approach, whenever there is proof of criminal illegality, the bank would have to parse the underlying transaction to separate the good from the bad. It seems preferable, whenever criminal illegality is demonstrated, to allow the issuing bank to refuse to

affect the bank's letter of credit payment obligation have generally not involved criminal illegality in Contract I. *But see* Brown v. United States Nat'l Bank, 220 Neb. 684, 371 N.W.2d 692 (1985) (possible criminal penalties for violation of the securities laws). In *KMW Int'l v. Chase Manhattan Bank, N.A.*, 606 F.2d 10 (2d Cir. 1979), the Second Circuit stated in dictum that "[t]here is nothing in the U.C.C. or the UCP which excuses an issuing bank from paying a letter of credit because of supervening illegality, impossibility, war or insurrection." *Id.* at 16. This could be interpreted—erroneously in the author's view—to mean that any illegality in Contract I has no effect on the letter of credit payment obligation. Such a broad reading would seem unwarranted since the precise issue of criminal illegality was not before the Second Circuit in the *KMW* case. On this issue of illegality in Contract I, see B. KOZOLCHYK, LETTERS OF CREDIT 122 n.708 (International Encyclopedia of Comparative Law, vol. 9, chapter 5, 1979) (German decision allowing an issuing bank to refuse payment based on the illegal nature of the goods being sold).

131. Statistics regarding national banks should prove this point. In 1985, there were 6840 cases involving national banks which were referred for criminal prosecution. In 1986, that number had risen to 11,451 and in 1987, the number was projected to be in excess of 12,000. *See* Remarks of Congressman Doug Barnard, Jr. at 21st Annual Banking Law Institute Conference on Legal Issues in Bank Lending, in Washington, D.C. (Nov. 16, 1987) (remarks entitled "Misconduct Inside Financial Institutions"). On a related point, several beneficiaries of letters of credit who presented forged documents to obtain payment have been prosecuted criminally. *See, e.g.,* United States v. Fermin Castillo, 829 F.2d 1194 (1st Cir. 1987); United States v. Tucker, 773 F.2d 136 (7th Cir. 1985).

132. In a different context, this approach was adopted by Lord Diplock in *United City Merchants (Invs.) Ltd. v. Royal Bank of Canada*, [1982] 2 All E.R. 720 (H.L.).

pay the entire amount of the credit, relegating seller *X* and buyer *Y* to enforce their respective rights under Contract I without the involvement of the issuing bank.

3. *Protection of the Letter of Credit Mechanism*

There is no question, however, that by allowing criminal illegality to breach the independence principle, the usefulness of letters of credit in international trade may be somewhat damaged. For example, suppose in Example 8 that First Bank's letter of credit was confirmed by a non-U.S. bank and that this non-U.S. confirming bank honored seller *X*'s draft not knowing of the commercial bribe. Once First Bank learns of the bribe, however, it will refuse to reimburse the non-U.S. confirming bank. If First Bank were within its rights in refusing to reimburse the non-U.S. confirming bank based on the criminal bribe in Contract I,¹³³ then the non-U.S. confirming bank would obviously think twice before confirming a second credit issued by First Bank or for that matter by any other issuing bank in State *M*. This attitude would hurt the usefulness of letters of credit as a lubricant for international trade.

4. *Protection of the Rights of State M*

In Example 8, protection of the issuing bank argues against extending the independence principle but protection of the letter of credit mechanism argues in favor of extending the independence principle. What seems to tilt the balance against extending the independence principle, however, is the interest of the forum state (State *M*). When a state (such as State *M*) makes an assessment that if certain conduct were allowed to continue within its borders, the conduct would ultimately harm more people than it would benefit, the state registers its disapproval by passing legislation criminalizing the conduct. In any balancing of interests, the strength of society's judgment regarding the harmfulness of conduct should be taken at face value and given strong, if not controlling, deference. Given this, any contract (even a collateral contract such as a letter of credit) which facilitates the commission of a crime in State *M* should be held unenforceable as a matter of State *M* contract law.

Thus, after balancing these various policy considerations, it seems that the independence principle should be breached in Example 8.¹³⁴ First Bank should not be

133. Of course, based on an analogy to U.C.C. § 5-114(2)(a), it could be argued that once there is a holder in due course of the beneficiary's draft (which the non-U.S. confirming bank presumably would be in this case), then First Bank cannot refuse to pay any holder in due course of the beneficiary's draft. U.C.C. § 5-114(2)(a) specifically provides that the issuing bank must pay the confirming (negotiating) bank who is a holder in due course regardless of whether the documents presented are forged or fraudulent. The analogy to U.C.C. § 5-114(2)(a), however, does not undermine the analysis in Example 8. U.C.C. § 5-114(2)(a) requires absolute payment if the beneficiary is perpetrating forgery or fraud as long as the confirming bank is an innocent holder in due course of the beneficiary's draft. The fraud or forgery mentioned in U.C.C. § 5-114(2)(a) would be fraud involving the performance of the underlying contract or involving the documents being presented. This type of fraud is a personal defense of the applicant and could not be asserted against a holder in due course of the draft under U.C.C. § 3-305(2)(c). Criminal illegality, however, is a real defense, good even against a holder in due course. U.C.C. § 3-305(2)(b).

134. Cf. Simont, *Letters of Credit and Guarantees on First Demand under Belgian Law*, LETTERS OF CREDIT REPORT, Mar.-Apr. 1988, at 1-3. This conclusion is consistent with the rules of negotiable instruments law. If an instrument has been negotiated as part of an illegal transaction, the negotiation may be subject to rescission (depending on the local law) although any rescission would not be good against a holder in due course. U.C.C. § 3-207(1)(c). Illegality "as renders the

held liable for wrongful dishonor of the letter of credit based on the presence of the criminal illegality in Contract I.¹³⁵

There are some who might dispute this conclusion, however, and argue in favor of applying the independence principle even in a case such as Example 8. These critics would argue that the independence principle should be breached only when the criminal conduct in Contract I is of a very serious nature. Contrast the case where the letter of credit is being used to pay a commercial bribe or a criminally usurious rate of interest with a case where the letter of credit is being used to pay for a shipment of cocaine or to guarantee payment of a murder contract. There is an ancient distinction in the criminal law between conduct which is *malum in se* and conduct which is simply *malum prohibitum*.¹³⁶ Society may criminalize both types of conduct but conduct such as murder and the sale of lethal commodities which is wrong by its very nature (*malum in se*) usually receives the stronger condemnation. Given this classic distinction, these critics might contend that the independence principle should be extended to allow the issuing bank to pay in the bribery and usury cases (*mala prohibita*) but not be extended to allow the issuing bank to pay in the cocaine and murder cases (*mala in se*).

Although superficially appealing, this distinction is essentially meaningless.¹³⁷ Letters of credit are supposed to represent swift and certain payment mechanisms. The types of activities deemed to be *mala in se* and the types of activities deemed to be *mala prohibita* are not always self evident. As a result, it will not be easy for an issuing bank to judge whether criminal conduct is either *malum in se* or *malum prohibitum*. All parties to a letter of credit transaction would be better served by a rule that is simpler and easier to apply.

Alternatively, a rule that uses the felony-misdemeanor distinction would be equally unsatisfactory. It is true that it may be easier for First Bank to differentiate between a felony and a misdemeanor than between a crime which is *malum in se* and a crime which is *malum prohibitum*. Still, First Bank or one of its officers would be ill advised to disregard evidence of a State *M* misdemeanor in Contract I and proceed to pay a letter of credit. There is no rule of the criminal law which immunizes a bank or a bank officer from being considered an accessory to a misdemeanor.

obligation of the party a nullity," however, is a real defense which would be good even against a holder in due course. U.C.C. § 3-305(2)(b).

135. The result, but not the analysis, in *Nadler v. Mei Loong Corp.*, 177 Misc. 263, 30 N.Y.S.2d 323 (Sup. Ct. 1941) may provide some indirect support for this conclusion. In *Nadler*, the applicant for the credit applied for and was granted an injunction against the issuing bank's payment of the credit based on fraud. Among the arguments made by the applicant to support its application for the fraud injunction was the fact that the United States had placed an embargo on goods imported from China. Because of the embargo, the goods being imported from China might have been removed from the ship and thus the bills of lading presented may have been fraudulent in that they no longer controlled the goods. *Id.* at 264, 30 N.Y.S.2d at 324. If the injunction had not been granted in this case, the issuing bank may have had to pay for goods which could not have been legally imported into the United States because of the embargo. The grant of the injunction is consistent with the conclusion of this Article that criminal illegality in Contract I can affect the bank's letter of credit payment obligation.

136. See R. PERKINS & R. BOYCE, *CRIMINAL LAW* 15-17, 880-96 (3d ed. 1982).

137. Several hundred years ago, Jeremy Bentham pointed out that this distinction "which being so shrewd and sounding so pretty, and being in Latin, has no sort of an occasion to have any meaning to it: accordingly it has none." J. BENTHAM, *A COMMENT ON THE COMMENTARIES AND A FRAGMENT ON GOVERNMENT* 63 (J. Burns & H. Hart, 1st ed. 1977).

One alternative solution to the problem presented by Example 8 has yet to be considered. The criminal conduct in Contract I could be allowed to affect the reimbursement agreement (Contract II) instead of the letter of credit (Contract III). In other words, despite the presence of the bribe in Contract I, First Bank could be required to honor its letter of credit obligation to seller *X*, thereby preserving the integrity of the letter of credit. The criminal conduct in Contract I, however, would breach the independence of Contract II—the issuing bank's reimbursement agreement with buyer *Y*. The presence of the bribe in Contract I would mean that First Bank would not be allowed reimbursement under Contract II for its letter of credit payment. The public policy goal of this approach is simple: because First Bank's reimbursement was denied, First Bank would obviously scrutinize carefully all transactions for which it issued letters of credit. This scrutiny would hopefully reduce the number of letters of credit issued in illegal transactions. The solution to Example 8 which is proposed in this Article—relieving the issuing bank of its payment obligation—leaves the consequences of the illegality with the parties to the underlying contract. The alternative solution of denying the issuing bank reimbursement leaves the consequences of the illegality with the issuing bank, an innocent party. It seems anomalous to resolve the problem by allowing the criminal (seller *X*) to be paid and then to make an innocent party (the issuing bank) suffer the loss.

D. Example 9—Commercial Bribery: Illegality Which Violates a Criminal Statute but Which Would not Expose the Issuer to Criminal Liability for Paying the Credit

Seller *X* (a resident of fictional country Mercuria) bribes a purchasing agent of buyer *Y* (in State *M*) to obtain the contract for the sale of the metal bolts. Seller *X* builds the amount of the bribe into the sales price of the bolts and requests buyer *Y* to have First Bank issue a letter of credit for this inflated sales price. First Bank issues the appropriate irrevocable letter of credit which is confirmed by Solid Gold Bank in Mercuria. It is assumed that commercial bribery is *not* a crime in Mercuria. When seller *X* presents his draft and documents to Solid Gold Bank (the confirming bank) for payment, Solid Gold Bank refuses to honor the credit because it has learned that Contract I was tainted with a commercial bribe, illegal under the law of State *M*. Seller *X* sues Solid Gold Bank in Mercuria for wrongful dishonor of the credit.

The leading case on whether foreign criminal illegality in the underlying sales contract can breach the independence principle and justify a confirming bank in refusing to pay a letter of credit is the House of Lords' decision in *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*.¹³⁸ In the *United City Merchants* case, an English seller and a Peruvian buyer entered into a scheme to violate Peruvian exchange control regulations. At the suggestion of the Peruvian buyer, the English seller agreed to sell goods to the Peruvian buyer at double their real

138. [1982] 2 All E.R. 720 (H.L.). For a related case involving a bank guarantee, see *J.H. Rayner (Mincing Lane) Ltd. v. Bank Fur Gemeinwirtschaft A.G.*, excerpted in *INT'L BANKING L.*, June 1983, at 9–11.

price. The Peruvian buyer needed an inflated invoice price because it wished to transfer dollars out of Peru in violation of Peru's exchange control regulations.¹³⁹ Under these regulations, Peru allowed dollars to be sent abroad to pay for imported goods.¹⁴⁰ Thus, by doubling the invoice price of the imported goods, the Peruvian buyer could remit excess dollars to the English seller. The English seller agreed to deposit these excess dollars in an account for the Peruvian buyer in the United States.

To carry out this scheme, the Peruvian buyer had a Peruvian bank issue a letter of credit in the inflated amount and had the credit confirmed by a bank in England. When the English seller sought payment under the credit, the English confirming bank refused payment claiming, *inter alia*, that payment of the amount sought by the seller would infringe Peruvian exchange control regulations. Under English law, monetary transactions which violate the exchange control regulations of a country which is a member of the Bretton Woods Agreements (such as Peru) were unenforceable in England.¹⁴¹

In his opinion, Lord Diplock ruled that, under the circumstances, the English confirming bank was not required to honor the seller's draw for the part of the purchase price of the goods that constituted the disguised money transaction. Although Lord Diplock emphasized that the Bretton Woods Agreements made the disguised money transaction only unenforceable (and not illegal) in England,¹⁴² its illegality under Peruvian exchange control regulations and its resulting unenforceability in England justified the confirming bank's refusal to pay part of the credit.¹⁴³

The result in *United City Merchants* may have been justified by England's treaty commitments under the Bretton Woods Agreements.¹⁴⁴ Leaving aside such complicating factors as treaty commitments, however, allowing the independence principle to be breached in Example 9—a case where it is assumed that the confirming bank that pays the credit will not be exposed to criminal liability with respect to the criminal conduct in Contract I—may be incorrect. When, in Example 9, the interests of the beneficiary, the confirming bank, and the forum state, and the protection of the letter of credit mechanism are all weighed, the balance seems to tilt in favor of extending the independence principle to insulate the letter of credit payment from the effects of State *M*'s criminal law.¹⁴⁵

In Example 9, since commercial bribery is assumed to be legal in Mercuria, seller *X*, the beneficiary of the credit, has not violated the criminal law of its own

139. *United City Merchants*, [1982] 2 All E.R. at 724.

140. *Id.* at 730.

141. Lord Diplock identified the monetary exchange contract that violated Peru's exchange control regulations as the agreement to exchange Peruvian currency provided by the buyer for \$331,043 to be deposited in a U.S. bank account. Because the price of the goods had been inflated to twice their value, this amount of Peruvian currency was not being used to pay the seller for goods. *Id.* at 730. The New York Court of Appeals refused to find that a letter of credit used to pay for goods was a monetary exchange contract within the scope of the Bretton Woods Agreements. See *J. Zeevi & Sons Ltd. v. Grindlays Bank (Uganda) Ltd.*, 37 N.Y.2d 220, 228–29, 333 N.E.2d 168, 174, 371 N.Y.S.2d 892, 900, *cert. denied*, 423 U.S. 866 (1975).

142. [1982] 2 All E.R. 720, 729.

143. *Id.* at 730.

144. *But see J. Zeevi & Sons Ltd.*, 37 N.Y.2d at 228–29, 333 N.E.2d at 174, 371 N.Y.S.2d at 900.

145. Not considered in this Article is the possible exposure of Solid Gold Bank to criminal penalties if one of its branches or subsidiaries was present in State *M*.

jurisdiction by bribing the purchasing agent of buyer *Y*. Thus, it would seem that seller *X* will have every expectation that the confirmation of Solid Gold Bank will be honored. The interests of Solid Gold Bank, however, are more difficult to assess. On one hand, since payment of its confirmation will neither violate the criminal law of Mercuria nor, it is assumed, expose Solid Gold Bank to possible prosecution for being an accessory to a violation of a foreign criminal statute,¹⁴⁶ Solid Gold Bank should wish to pay the credit in order to uphold its commercial honor. On the other hand, Solid Gold Bank will realize that if it honors its confirmation, First Bank will be precluded from reimbursing Solid Gold Bank given the illegality of commercial bribery in State *M*. Since this is the case, Solid Gold Bank might prefer to be relieved of its obligation to honor its confirmation. As for the letter of credit mechanism itself, breaching the independence principle, no matter what the reason, damages the mechanism. But to breach the independence principle in this case would have particularly serious consequences. One of the reasons why a foreign seller such as seller *X* requests a *confirmed* letter of credit is to shift the so-called “sovereign risk” to the confirming bank. Understandably, a seller in a foreign country will be worried that financial or political acts in the country where the issuing bank is located may interrupt payment of the letter of credit.¹⁴⁷ By confirming a credit, a local bank undertakes its own independent payment obligation to the seller-beneficiary. As a consequence, by confirming a credit, the confirming bank assumes the “sovereign risk” because it guarantees that it will honor the credit regardless of the ability of the issuing bank to pay the credit. Breaching the independence principle to require a confirming bank to enforce the criminal laws of a foreign jurisdiction would seem to undermine this standard risk allocation inherent in letter of credit confirmations.

Finally, the interests of the forum state (Mercuria in this case) are not necessarily furthered by breaching the independence principle and subjecting Solid Gold Bank to the penal jurisdiction of State *M*. Under the foreign relations law of the United States, a court in the United States “need not recognize a judgment of the court of a foreign state if: . . . (d) the cause of action on which the judgment was based . . . is repugnant to the public policy of the United States or of the State where recognition is sought.”¹⁴⁸ If a similar rule exists in Mercuria and if Mercuria recognizes the importance of letters of credit to its economy, Mercuria will most likely refuse to give effect to the penal laws of State *M*. To allow commercial bribery—a crime in State *M* but not a crime in Mercuria—to affect a confirming bank’s payment obligation in Mercuria would undermine the commercial usefulness of letters of credit in Mercuria, thereby contravening the public policy and economic interests of Mercuria.

The New York Court of Appeals decision in *J. Zeevi & Sons, Ltd. v. Grindlays Bank (Uganda) Ltd.*¹⁴⁹ seems to support the conclusion of this Article that the

146. See *supra* note 145.

147. Consider, for example, President Carter’s order to freeze letter of credit payments to Iranian beneficiaries. See 31 C.F.R. § 535.201 (1987); 31 C.F.R. § 535.568 (1987).

148. See RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 482(2)(d) (1987).

149. 37 N.Y.2d 220, 333 N.E.2d 168, 371 N.Y.S.2d 892, *cert. denied*, 423 U.S. 866 (1975).

independence principle should not be breached in a case such as Example 9. In *J. Zeevi & Sons*,¹⁵⁰ the government of Uganda ordered Grindlays Bank in Uganda to cancel a letter of credit issued in favor of an Israeli beneficiary and to effect no reimbursement of any payments made under the credit. Grindlays' credit, however, had provided that any negotiating bank could seek reimbursement for payments made under the credit at Grindlays' correspondent bank in New York.¹⁵¹ After a negotiating bank was denied payment by Grindlays' New York reimbursing bank, the beneficiary itself sued Grindlays Bank by attaching assets of Grindlays held by the New York reimbursing bank.¹⁵² Despite the fact that the letter of credit payment had been rendered illegal under Ugandan law, the New York Court of Appeals ordered payment in New York.¹⁵³ Among the reasons cited by the New York Court of Appeals was the State of New York's "overriding and paramount interest in the outcome of [the] litigation."¹⁵⁴ Because of the vast amount of letter of credit business done in the state, New York had an interest in making sure that letters of credit were paid. Thus, by permitting reimbursement in New York for payments made under the credit, the Ugandan issuing bank had to accept New York's policy of protecting the integrity of letters of credit.¹⁵⁵

IV. POSTSCRIPT ON UCC SECTION 5-114(2)

Before concluding this Article, a final look at UCC section 5-114(2) is in order. If it is broadly interpreted, UCC section 5-114(2) may provide a textual basis for permitting an issuing or confirming bank to dishonor a credit when there is criminal illegality in the underlying transaction.

UCC section 5-114(2) lists those latent defects in documents which will either justify an issuing or confirming bank in dishonoring a credit or justify an injunction against honor. A required document which is forged or fraudulent will obviously justify dishonor but so will a document which "does not in fact conform to the warranties made on negotiation or transfer of a document of title (UCC section 7-507)."¹⁵⁶ Among the UCC section 7-507 warranties made by a person who

150. *Id.* at 224, 333 N.E.2d at 171, 371 N.Y.S.2d at 896.

151. *Id.* at 224, 333 N.E.2d at 171, 371 N.Y.S.2d at 895.

152. *Id.* at 225, 333 N.E.2d at 171, 371 N.Y.S.2d at 896.

153. *Id.* at 228-29, 333 N.E.2d at 171, 371 N.Y.S.2d at 900.

154. *Id.* at 223-25, 333 N.E.2d at 170-71, 371 N.Y.S.2d at 895-96. Similarly, in *Banco de Vizcaya v. First Nat'l Bank*, 514 F. Supp. 1280 (N.D. Ill. 1981), an Illinois court required the home office of First National Bank of Chicago to pay a letter of credit even though a court injunction in Abu Dhabi prevented payment of the credit by the Abu Dhabi branch of First Chicago that had issued the credit. The Illinois court rested its decision on the commercial value of letters of credit to Illinois. "The public interest in enforcing irrevocable letters of credit and providing a safe and reliable haven for international letters of credit and for international trade in Illinois is manifest." *Id.* at 1287.

155. *But see* Sabolyk v. Morgan Guar. Trust Co., No. 84 Civ. 3179, slip op. (S.D.N.Y. Nov. 27, 1984).

156. U.C.C. § 5-114(2). In its turn, article 7 provides in relevant part: "Where a person negotiates or transfers a document of title for value otherwise than as a mere intermediary . . . , then unless otherwise agreed he warrants to his immediate purchaser only in addition to any warranty made in selling the goods (a) that the document is genuine; and (b) that he has no knowledge of any fact which would impair its validity or worth; and (c) that his negotiation or transfer is rightful and fully effective with respect to the title to the document and the goods it represents." U.C.C. § 7-507.

transfers a document of title for value is a warranty "that he has no knowledge of any fact which would impair its validity or worth."¹⁵⁷

What this language means in the context of a letter of credit case is unclear.¹⁵⁸ An argument can be made, however, that UCC section 7-507(b), as incorporated in UCC section 5-114(2), would allow the issuing bank in Example 8 to refuse to honor the credit since the bill of lading presented by the beneficiary states an inflated value for the goods shipped.¹⁵⁹ For the same reason, assuming the UCC applied to the transaction, UCC section 7-507(b) might also allow the confirming bank in Example 9 to refuse to honor its payment obligation. In both cases, when the beneficiary transferred the bill of lading to the bank, the beneficiary knew a fact which arguably impaired the worth and validity of the bill of lading (and therefore the goods represented by the bill of lading).

As has been pointed out elsewhere, however, "the practical consequence of the section 7-507(b) ground for dishonor is that an issuer or its customer may achieve dishonor even in cases where a defect in the goods, or a misdescription in the document of title, is relatively minor, so long as the defect or misdescription is sufficient to impair the worth of the document of title."¹⁶⁰ If UCC section 7-507(b) were to be interpreted in this fashion, it would create a gaping chasm in the independence principle and undermine the certainty and predictability of letter of credit payments. Thus, resort to the UCC section 7-507(b) warranty to justify dishonor, even in cases of illegality, seems to be ill advised. The balancing approach suggested in this Article, although perhaps more complicated, provides a firmer footing for the analysis.

V. CONCLUSION

The conclusion of this Article will trouble those who believe that the independence principle should always insulate an issuing or confirming bank's payment obligation from the effects of the underlying contract which generated the credit. But letter of credit law recognizes no such absolute rule. Serious fraud in the underlying transaction is a recognized exception to the independence principle.¹⁶¹ Based on the analysis presented in this Article, a second exception should also be recognized. Breaching the independence principle and relieving the issuing or confirming bank from honoring its letter of credit obligation seems to represent a reasonable accommodation of all of the interests protected by the independence principle when there is criminal illegality in Contract I, and by paying the letter of credit, the issuing or confirming bank would expose itself to penal sanctions for abetting this criminal conduct.

157. U.C.C. § 7-507(b).

158. See Macintosh, *Letters of Credit: Dishonor When a Required Document Fails to Conform to the Section 7-507(b) Warranty*, 6 J. L. & Com. 1 (1986).

159. The price of the goods stated in the bill of lading (the document of title) would contain the amount of the commercial bribe. U.C.C. § 5-114(2) might also be read as providing that the beneficiary makes the same U.C.C. § 7-507 warranties with respect to any required document transferred, as he does with respect to a required document of title transferred. If this reading were accepted, the beneficiary would make U.C.C. § 7-507(b) warranties with respect to the commercial invoice as well as the bill of lading. *Contra* Macintosh, *supra* note 158, at 3 n.7.

160. Macintosh, *supra* note 158, at 15-16.

161. See U.C.C. § 5-114(2).

